EKATVAM ACADEMY

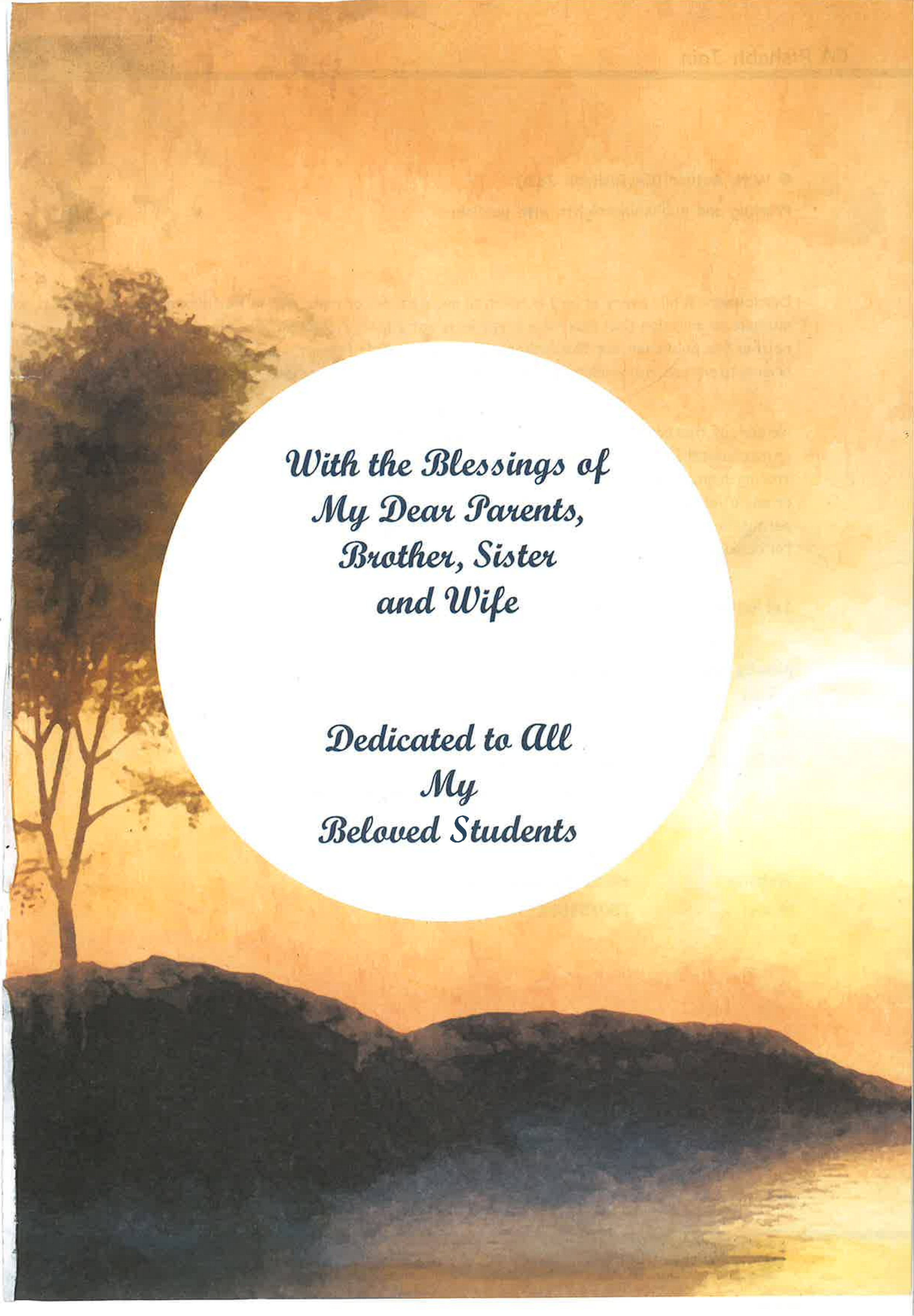
CA INTER

NEW SYLLABUS

AUDITING & ETHICS

Module-2

CA Rishabh Jain



With the Blessings of
My Dear Parents,
Brother, Sister
and Wife

Dedicated to All
My
Beloved Students

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Phone:	7507545533

Acknowledgments

There are people in this world, some of them so wonderful, that made this book become a reality that you are holding in your hand. I would like to thank all of them.

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Mr. Sharad Patil who has taken immense effort in creating this Book.
&
Mr. Sagar Dhumal who has taken immense efforts in Designing this book in the most creative way.

"Alone we can do so little, together we can do so much"

PREFACE

Dear students,

It gives me immense joy and pleasure to present a completely updated CA Inter - Auditing & Ethics Module 2 strictly as per ICAI New Syllabus.

This new version of Module 2 contains chapters such as Nature Objective & Scope of Audit, Internal control, Audit of items of Financial Statements, Special Features of different types of entities, Bank audit and Professional ethics & its Principles as per ICAI New syllabus.

This book was prepared with the aim of making sure that anyone who reads this gets not only a substantial coverage over the ICAI syllabus but also, resounding confidence over their practical applicability when you are working in the corporate world.

Having been a professor for 10 years and counting, I have observed that, for you to succeed in exam.and your professional career you need a great understanding of the concept and its real-life application. Majority students get stuck in the rat race of just passing the exam by any means, this may help you to pass a competitive exam but not in the exam of your professional life.

I have worked for more than 6 years in Big 4's like PWC and Deloitte in my initial years of professional career and the lessons learned during that time has inspired me to ensure that my students get a "Practical Approach" to this so called "Theoretical world of Auditing".

The journey of a Chartered Accountant is not a rapid T-20 match. It is equivalent to a 5-day test match, if you will. Rather than rushing and blasting through your preparation, it is crucial to be consistent and disciplined. My cricket coach once said to me something that has stuck with me since my college days - 'Wicket pe bane raho, runs aapne aap ban jaayenge!'

I wish you all the best and hope that you be greatly benefited from this book!
Happy Learning,

Regards
CA Rishabh Jain
rishabhrgolchha@gmail.com
www.ekatvamacademy.com

'Failure will never overtake me if my determination to succeed is strong enough!'
- Late Dr. A P J Abdul Kalam

CA INTERMEDIATE

Auditing and Ethics

Module - 2

Index

Ch. No.	Chapter Name	Page Nos.
1	Nature, Objective and Scope of Audit	1.1 - 1.18
2	Audit Strategy, Audit Planning and Audit Programme	2.1 - 2.2
3	Risk Assessment and Internal Control	3.1 - 3.30
4	Audit Evidence	4.1 - 4.2
5A	Introduction	5A.1 - 5A.8
5B	Balance Sheet Captions (Liabilities)	5B.1 - 5B.26
5C	Balance Sheet Captions (Assets)	5C.1 - 5C.28
5D	Statement of Profit and Loss Captions	5D.1 - 5D.20
6	Audit Documentation	6.1 - 6.2
7	Completion and Review	7.1 - 7.2
8	Audit Report	8.1 - 8.14
9A	Audit of Different Types of Entities	9A.1 - 9D.30
9B	Government Audit	9B.1 - 9B.12
9C	Audit of Cooperative Societies	9C.1 - 9C.14
9D	Audit of Trusts and Societies	9D.1 -9D.6
10	Audit of Banks	10.1-10.38
11	Ethics and Terms of Audit Engagements	11.1-11.10

RJ = Practical Insight into Theoretical World

Nature, Objective & Scope of Audit

ORIGIN OF AUDITING

1) Auditing has existed even in ancient times in many societies of world including India. The reference to auditing is found in Kautilya's Arthshastra even in 4^{th} century BC. It talks about fixed accounting year, a process for closure of accounts and audit for the same. **Concepts of periodical checking and verification** existed even in those times.
2) The word **"audit"** originates from Latin word **"audire" meaning "to hear"**. In medieval times, auditors used to hear the accounts read out to them to check that employees were not careless and negligent.
3) Coming to more recent history, the first Auditor General of India was appointed in British India in 1860 having both accounting and auditing functions. Later on, office of Auditor General was given statutory recognition.
4) Presently, **Comptroller and Auditor General of India** is an independent constitutional authority **responsible for auditing government receipts and expenditures**.
5) The Institute of Chartered Accountants of India was established as a statutory body under an Act of Parliament in 1949 for regulating the profession of Chartered Accountancy in the country.

MEANING AND NATURE OF AUDITING

"An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Analysis of the Definition

An incisive analysis of above meaning of auditing brings out following points clearly: -

1) Audit is an **independent examination** of financial information.

Note:

a) Independence, here, implies that the **judgement of a person is not subordinate** to the wishes or direction of another person who might have engaged him. The auditor should be independent of entity whose financial statements are subject to audit so that **he can form an opinion without being affected by any influence**. Independence increases auditor's ability to act objectively without creeping in of any biases.

b) Consider, for example, a person who requests his brother, a Chartered Accountant, to audit accounts of his proprietary concern and issue a report. Can CA audit accounts of concern in which his brother is sole proprietor? No, he cannot. It is due to the fact that there would be no independence in such a case due to relationship by birth between CA and his brother. He would be subject to influence from his brother.

c) Take another case where a CA has invested in shares of a company. Can he audit accounts of such a company in which he holds shares? The answer is resounding NO. It is due to the fact that by holding shares of the company, his own self-interest gets involved. His own money is invested in the company and he may not be able to form judgment independently on the financial statements of the company.

2) The entity whose financial information is examined **need not necessarily be profit oriented** like in case of a business. It can be a non-profit organization like an NGO or a charitable trust. Audit can be undertaken in respect of any organization be it a **small, medium or large**. Further, it can be conducted for any entity irrespective of its legal structure i.e. such an entity may be a **proprietary concern, a partnership firm, a LLP, a private company, a public company, a society or a trust**.
3) The purpose of audit is to **express an opinion** on the financial statements.
4) Understand that **preparation and presentation of financial statements** of an entity is **responsibility of management** of entity.
5) The auditor **expresses an opinion on financial statements** by means of written audit report.

In doing so, he has to see that financial statements would not mislead anybody by ensuring that:

a) the **accounts** have been drawn up with reference to **entries in the books of account;**
b) the entries in the books of account are **adequately supported by sufficient and appropriate evidence;**
c) none of the entries in the books of account has been **omitted** in the process of compilation;
d) the information conveyed by the statements is **clear and unambiguous;**
e) the **financial statement** amounts are properly **classified, described and disclosed** in conformity with accounting standards; and
f) the statement of accounts presents a **true and fair picture** of the operational results and of the assets and liabilities.

Conclusion

Auditing provides assurance. Its basic nature *lies* in providing assurance to users - providing confidence to users of financial statements. Such an assurance **lends credibility to financial statements**. Audited financial statements provide confidence to users that financial information reflected in financial statements can be relied upon.

INTERDISCIPLINARY NATURE OF AUDITING-RELATIONSHIP WITH DIVERSE SUBJECTS

Auditing is **interdisciplinary** in nature. It draws from diverse subjects including accountancy, law, behavioral science, statistics, economics and financial management and makes use of these subjects.

1) **Auditing and Accounting**: Auditing reviews the financial statements which are nothing but a result of the **overall accounting process**.
2) **Auditing and Law**: An auditor should have a **good knowledge of business laws** affecting the entity.

3) <u>Auditing and Economics</u>: Auditor is expected to be familiar with the **overall economic environment** of the client.
4) <u>Auditing and Behavioral Science</u>: **Knowledge of human behavior** is essential for an auditor to effectively discharge his duties
5) <u>Auditing and Statistics & Mathematics:</u> Auditor is also expected to have the knowledge of **statistical sampling for meaningful conclusions and mathematics for verification of inventories.**
6) <u>Auditing and Data Processing:</u> **EDP** auditing in itself is developing as a **discipline in itself**.
7) <u>Auditing and Financial Management:</u> The auditor is expected to have knowledge about various **financial techniques** such as working capital management, funds flow, ratio analysis, capital budgeting etc.
8) <u>Auditing and Production</u>: Good auditor is one who **understands the client and his business functions** such as production, cost system, marketing etc.

OBJECTIVE OF AN AUDIT

In conducting audit of financial statements, objectives of auditor in accordance with SA-200 "**Overall Objectives of the Independent auditor** and the conduct of an audit in accordance with Standards on Auditing" are:

a) To **obtain reasonable assurance** about whether the financial statements as a whole are free from material misstatement; and whether due to fraud or error, thereby enabling the auditor to **express an opinion** on whether the financial statements are prepared, in all material respects, in accordance with an **applicable financial reporting framework**; and
b) To **report on the financial statements, and communicate as required by the SAs**, in accordance with the auditor's findings.

An analysis of above brings out following points clearly: -

1) Auditor's objective is to obtain a reasonable assurance whether financial statements as a whole are free from material misstatement whether due to fraud or error.
2) Reasonable assurance is to be distinguished from absolute assurance. **Absolute assurance is a complete assurance** or a guarantee that financial statements are free from material misstatements. However, **reasonable assurance is not a complete guarantee**. Although it is a high-level of assurance but it is not complete assurance.
3) Audit of financial statements is carried out by the auditor with professional competence and skills in accordance with Standards on Auditing. Audit procedures are applied in accordance with SAs, audit evidence is obtained and evaluated. On basis of that, conclusions are drawn and opinion is formed. It leads to **high level of assurance** which is called as **reasonable assurance** but it is not absolute assurance.
4) Misstatements in financial statements can occur due to **fraud or error or both**. The auditor seeks to obtain reasonable assurance whether financial statements as a whole are free from material misstatements caused by fraud or error. He has to see effect of misstatements on

financial statements **as a whole, in totality**.

5) Obtaining reasonable assurance that financial statements as a whole are free from material misstatements enables the auditor **to express an opinion** on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

6) The **opinion is reported and communicated** in accordance with audit findings through a written report as required by **Standards on Auditing**.

SCOPE OF AUDIT

1) The **purpose of an audit** is to enhance the **degree of confidence of intended users** in the financial statements. Users of financial statements may be **shareholders, employees, customers, government and regulatory authorities**, bankers etc.

2) Enhancing of degree of confidence is achieved by the **expression of an opinion** by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

3) ***Applicable financial reporting framework*** means a framework adopted in the preparation and presentation of the financial statements that is **acceptable in view** of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

   For example, *in case of companies in India*, financial reporting framework is provided under **Schedule III of Companies Act, 2013**.

The following points are included in scope of audit of financial statements:

1) **Coverage of all aspects of entity**

Audit of financial statements should be **organized adequately** to cover all aspects of the entity relevant to the financial statements being audited.

2) **Reliability and sufficiency of financial information**

a) The auditor should be reasonably satisfied that **information contained in underlying accounting records and other *source* data** (like bills, vouchers, documents etc.) is ***reliable and sufficient*** basis for preparation of financial statements.

b) The auditor makes a judgment of reliability and sufficiency of financial information by making a study and assessment of accounting systems and internal controls and by **carrying out appropriate tests, enquiries and procedures**.

3) **Proper disclosure of financial information**

a) The auditor should also decide whether relevant information is **properly disclosed** in the financial statements. He should also keep in mind **applicable statutory requirements** in this regard.

It is done by ensuring that financial statements properly **summarize transactions and events** recorded therein and by considering the judgments made by management in preparation of financial statements.

b) The management responsible for preparation and presentation of financial statements **makes many judgments** in this process of preparing and presenting financial statements. For example, ***choosing of appropriate accounting policies*** in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

c) The auditor evaluates **selection and consistent application of accounting policies** by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

d) Understand that financial statements of an entity are **prepared on historical financial information basis**. *"Historical financial information"* means information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

For example, when purchases and sales are reflected in financial statements of an entity, these are examples of historical financial information. These are about transactions which have occurred in past.

Note:

Since financial statements are prepared on the basis of historical financial information, it is logical that audit of financial statements is also **based upon such historical financial information**. Therefore, audit of financial statements is based upon historical financial information.

SCOPE OF AUDIT-WHAT IT DOES NOT INCLUDE

1) Auditor is **not expected** to perform duties which fall outside domain of his competence. **For example,** physical condition of certain assets like that of sophisticated machinery cannot be determined by him.
2) Similarly, it is **not expected** from an auditor **to determine suitability** and life of civil structures like buildings. These require different skillsets which may be performed by qualified engineers in their respective fields.
3) An auditor is **not an expert** in authentication of documents. The genuineness of documents **cannot** be authenticated by him because he is **not an expert** in this field.
4) **An audit is not an official investigation into alleged wrong doing.** He does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation.

AUDITING VS INVESTIGATION

1) **Audit is distinct from investigation.** Investigation is a **critical examination** of the accounts with a special purpose.

   For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.
2) The **objective of audit,** on the other hand as we have already discussed, is to obtain **reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.
3) The **scope of audit is general and broad** whereas **scope of investigation is specific and narrow.**
4) However, it is quite possible that sometimes **investigation results from the prima facie findings of the auditor.** It may happen that auditor has given some findings of serious concern. Such findings may prompt for calling an investigation.

AUDIT- MANDATORY OR VOLUNTARY?

1) It is not necessary that **audit is always legally mandatory.** There are entities like companies who are compulsorily required to get their accounts audited under law. Even non-corporate entities may be compulsorily requiring audit of their accounts under tax laws.
2) **For example,** in India, every person is required to get accounts audited if turnover crosses certain threshold limit under income tax law.
3) It is also possible that **some entities like schools** may be required to get their accounts audited for the **purpose of obtaining grant or assistance from the Government.**
4) **Audit is not always mandatory.** Many entities may get their accounts audited voluntarily

because of benefits from the process of audit. Many such concerns have their internal rules requiring audit due to advantages flowing from an audit.

WHAT IS AN ENGAGEMENT?

Engagement means an . In the context of auditing, it means a **formal agreement between auditor and client** under which auditor agrees to provide auditing services. It takes the shape of engagement letter.

External audit engagements

The purpose of external audit engagements is to enhance the **degree of confidence of intended users** of financial statements. Such engagements are also reasonable assurance engagements.

For example, in India, companies are required to get their annual accounts audited by an external auditor. Even **non-corporate entities** may choose to have their accounts audited by an external auditor **because of benefits of such an audit**.

BENEFITS OF AUDIT - WHY AUDIT IS NEEDED

1) Audited accounts **provide high quality information**. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.
2) **In case of companies**, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management consisting of directors. As **shareholders are owners** of the company, they **need an independent mechanism** so that financial information is qualitative and reliable. **Hence, their interest is safeguarded by an audit**.
3) An **audit acts as a moral check on employees** from committing frauds for the fear of being discovered by audit.
4) Audited financial statements are **helpful to government authorities** for determining **tax liabilities**.
5) Audited financial statements can be **relied upon by lenders, bankers** for making their credit decisions i.e. whether to lend or not to lend to a particular entity.
6) An audit may also **detect fraud or error or both**.
7) An audit reviews existence and operations of various controls operating in any entity. Hence, it is **useful at pointing out deficiencies**.

WHO APPOINTS AN AUDITOR?

1) Generally, an **auditor is appointed by owners** or in some cases by **constitutional or government authorities** in accordance with applicable laws and regulations.

   For example, in case of companies, auditor is appointed by members (shareholders) in Annual

General Meeting (AGM). Shareholders are owners of a company and auditor is appointed by them in AGM.

2) However, in case of **government companies in India**, auditor is appointed by **Comptroller and Auditor General of India (CAG)**, an independent constitutional authority.
3) Take case of a **firm** who engages an auditor to audit its accounts. In such a case, auditor is appointed by **partners of firm**.
4) There may be a situation in which auditor may be appointed by a government authority in accordance with some law or regulation. For example, an auditor may be appointed under tax laws by a government authority.

TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

1) The outcome of an audit is written audit report in which auditor expresses an opinion. The **report is submitted to person making the appointment**.
2) In case of companies, these are shareholders- in case of a firm, to partners who have engaged him.

QUALITIES OF AUDITOR

1) An auditor is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent.
2) **Tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability** are some of qualities which an auditor should have. In short, all those personal qualities that **go to make a good businessman** contribute to the **making of a good auditor**.
3) In addition, he must have the shine of culture for attaining a great height. He must have **the highest degree of integrity** backed by **adequate independence**.
4) The auditor, **who holds a position of trust**, must have the basic human qualities apart from the technical requirement of professional training and education. He is called upon constantly to ***critically* review** financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert.
5) An **exhaustive knowledge of accounting** in all its branches is the ***sine qua non*** of the practice of auditing. He must know thoroughly all accounting principles and techniques.

CONCEPT OF TRUE AND FAIR

1) The concept of true and fair is a **fundamental concept** in auditing.
2) The phrase **"true and fair"** in the auditor's report signifies that the auditor is required to **express his opinion** as to whether the state of a airs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.
3) This requires that the **auditor should examine the accounts with a view to verify** that all assets, liabilities, income and expenses are stated as amounts which are **in accordance with accounting principles and policies** which are relevant and no material amount, item or transaction has been omitted.
4) **What constitutes a 'true and fair' view is a matter of an auditor's judgment in the particular circumstances of a case.**
5) **In more specific terms, to ensure true and fair view, an auditor has to see:**
    a) that the assets are neither undervalued or overvalued, according to the applicable accounting principles,
    b) no material asset is omitted;
    c) the charge, if any, on assets are disclosed;
    d) material liabilities should not be omitted;
    e) the profit and loss account and balance sheet discloses all the matters required to be disclosed;
    f) accounting policies have been followed consistently; and
    g) all unusual, exceptional or non-recurring items have been disclosed separately

Note:

1) **SA 700 "Forming an Opinion and Reporting on Financial Statements"**, requires the auditor to form an **opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained**; and **express clearly that opinion through a written report** that also describes the basis for the opinion.
2) The auditor is required to **express his opinion on the financial statements** that, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with Accounting Standards.

MEANING OF ASSURANCE ENGAGEMENT

"Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to **enhance the degree of confidence of the intended users** other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

It means that the **practitioner gives an opinion** about specific information due to which users of information are able to make confident decisions knowing well that **chance of information being incorrect is diminished.**

ELEMENTS OF AN ASSURANCE ENGAGEMENT

Following elements comprise an assurance engagement: -

1) **A three party relationship involving a practitioner, a responsible party, and intended users**

   An assurance engagement involves abovesaid three parties.

   a) A **practitioner** is a person who provides the assurance. The term practitioner is **broader than auditor**. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.

   b) A **responsible party** is the party responsible for **preparation of subject matter**.

   c) **Intended users** are the persons for whom an assurance report is prepared.These persons may use the report in making decisions.

2) **An appropriate subject matter**

   It refers to the **information to be examined** by the practitioner. For example, financial information contained in financial statements while conducting audit of financial statements.

3) **Suitable criteria**

   These refer to **benchmarks used to evaluate** the subject matter like **standards, guidance, laws, rules and regulations**.

4) **Sufficient appropriate evidence**

   The practitioner performs an assurance engagement to obtain sufficient appropriate evidence. It is on the basis of evidence that conclusions are arrived and an opinion is formed by auditor.

   "Sufficient" relates to **quantity of evidence** obtained by auditor. **"Appropriate"** relates to **quality of evidence** obtained by auditor. Evidence should be **both sufficient and appropriate**.

5) **A written assurance report in appropriate form**

   A written report is provided containing **conclusion that conveys the assurance** about the subject matter. A written assurance report is the **outcome of an assurance engagement**.

MEANING OF REVIEW: AUDIT VS. REVIEW

1) We have learnt that audit is a reasonable assurance engagement. It provides reasonable assurance.
2) However, review is a limited assurance engagement. It provides lower level of assurance than audit.
3) Further, review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up.
4) However, both "audit" and "review" are related to financial statements prepared on the basis of historical financial information.

TYPES OF ASSURANCE ENGAGEMENTS- REASONABLE ASSURANCE ENGAGEMENT VS LIMITED ASSURANCE ENGAGEMENT

1) As already discussed, assurance engagements provide assurance to users. The difference is of degree. Reasonable assurance engagement like audit provides reasonable assurance which is a high level of assurance. Limited assurance engagement like review provides lower level of assurance than audit. It is only a moderate level of assurance.

Reasonable assurance engagement	Limited assurance engagement
1) Reasonable assurance engagement provides high level of assurance.	1) Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
2) It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	2) It performs fewer procedures as compared to reasonable assurance engagement.
3) It draws reasonable conclusions on the basis of sufficient appropriate evidence.	3) It involves obtaining sufficient appropriate evidence to draw limited conclusions.
4) Example of reasonable assurance engagement is an audit engagement.	4) Example of limited assurance engagement is review engagement.

2) Besides reasonable assurance engagements and limited assurance engagements, there is another kind of assurance which is related to matters other than historical financial information. Such an assurance may relate to prospective financial information and not to historical financial information. It may relate to providing assurance on internal controls in an entity.
3) "Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It can be in the form of a forecast or projection or combination of both.

4) It is to be noted that in such type of assurance engagements, **examination is not of historical financial information**.
5) Here, it is important to note the difference between **"Historical financial information" and "Prospective financial information."** The **former** relates to information expressed in financial terms of an entity about **economic events, conditions or circumstances occurring in past periods**. The **latter** relates to financial information based on **assumptions about occurrence of future events and possible actions by an entity**.
6) Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events.
7) In assurance reports involving prospective financial information, the practitioner obtains **sufficient appropriate evidence** to the effect that **management's assumptions on which the prospective financial information** is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions and it is properly presented and all material assumptions are adequately disclosed.
8) **Prospective financial information relates to future events**. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented. The auditor is, therefore, **not in a position to express an opinion** as to whether the results shown in the prospective financial information will be achieved.
9) Therefore, in such **assurance engagements**, practitioner provides **a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection**.
10) Hence, such type of assurance engagement provides only a **"moderate" level of assurance**.

<u>Examples of assurance engagements</u>

Example of engagement assurance	Type of assurance engagement
Audit of statements financial	Reasonable assurance engagement
Review of financial statements	Limited assurance engagement
Examination of Prospective financial information	Provides assurance regarding reasonability of assumptions forming basis of projections and related matters
Report on controls operating at an organization	Provides assurance regarding design and operation of controls

- Assurance Engagements
  - Reasonable Assurance Engagement
    - Audit
  - Limited Assurance Engagement
    - Review
  - Assurance Engagements dealing with matters other than historical financial information
    - Examination of prospective financial information (like forecast) or assurance regarding operations of controls

ENGAGEMENT AND QUALITY CONTROL STANDARDS: AN OVERVIEW

The following Standards issued under authority of ICAI Council are collectively known as *Engagement Standards:* -

1) **Standards on auditing (SAs)** which apply in **audit** of **historical financial information.**
2) **Standards on review engagements (SREs)** which apply in **review** of **historical financial information.**
3) **Standards on Assurance engagements (SAEs)** which apply in **assurance engagements other than audits and review** of historical financial information.
4) **Standards on Related Services (SRSs)** which apply in **agreed upon procedures** to information, **compilation engagements** and other related service engagements.

The purpose of issue of these standards is to **establish high quality standards and guidance** in the areas of financial statement audits and in other types of assurance services.

STANDARDS ON AUDITING

1) Standards on Auditing apply in the context of an **audit of financial statements** by an independent auditor. It is important to remember that Standards on Auditing apply in **audit of historical information.** These establish high quality benchmarks and are followed by auditors in conducting audit of financial statements.
2) Standards on Auditing have been issued on wide spectrum of issues in the field of auditing ranging from **overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement,**

audit sampling, audit evidence and forming an opinion and reporting on financial statements. These cover all significant aspects of audit of financial statements.

3) Some examples of Standards on Auditing are: -
   a) SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing
   b) SA 230 Audit Documentation
   c) SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
   d) SA 500 Audit Evidence
   e) Revised SA 700 Forming an Opinion and Reporting on Financial Statements

STANDARDS ON REVIEW ENGAGEMENTS

1) Standards on review engagements apply in the context of review of financial statements. We have already understood that review is a limited assurance engagement and it provides assurance which is lower than that provided by audit.
2) It is due to the fact that review involves fewer procedures as compared to audit. Since a review also provides assurance to users, it also involves obtaining sufficient appropriate evidence. For example, when an auditor performs review of interim financial information of an entity.
3) Examples of Standards on Review engagements are:
   a) SRE 2400 (Revised) Engagements to Review Historical Financial Statements
   b) SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity
4) It is to be noted that both Standards on auditing and Standards on review engagements apply to engagements involving historical financial information.

STANDARDS ON ASSURANCE ENGAGEMENTS

1) There is another set of standards which apply in assurance engagements dealing with subject matters other than historical financial information. Such assurance engagements do not include "audit" or "review" of historical financial information. These standards are known as Standards on Assurance Engagements.
2) For example, an assurance engagement relating to examination of prospective financial information.
3) It is to be noted that in such type of assurance engagements, examination is not of historical financial information or engagement may relate to providing assurance regarding non-financial matters like design and operation of internal control in an entity.
4) Examples of Standards on Assurance Engagements are:
   a) SAE 3400 The Examination of Prospective Financial Information

b) SAE 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

STANDARDS ON RELATED SERVICES

1) Lastly, there are standards on related services. These standards apply in engagements to perform agreed-upon procedures regarding financial information.
2) For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements.
3) An engagement in which practitioner may be called upon to assist management with the preparation and presentation of historical financial information without obtaining assurance on that information. Such type of compilation engagements fall in the category of related services and practitioner issues a report clearly stating that it is not an assurance engagement and no opinion is being expressed.
4) These types of services are called related services and standards have been issued to deal with practitioner's responsibilities in this regard.
5) **Examples of Standards on related services are:**

   a) SRS 4400 Engagements to perform agreed-upon procedures regarding financial information

   b) SRS 4410 (Revised) Compilation engagements

<u>Note</u>

It is to be clearly understood that all the following standards are collectively known as the Engagement Standards:

a) Standards on Auditing (SAs),
b) Standards on Review Engagements (SREs),
c) Standards on Assurance Engagements (SAEs) and
d) Standards on related services (SRSs)

STANDARDS ON QUALITY CONTROL

1) Standards on Quality Control (SQCs) have been issued to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for the conduct of audit and review of historical financial information and for other assurance and related service engagements.
2) SQC 1 has been issued in this regard. It requires auditors/practitioners to establish system of quality control so that firm and its personnel comply with professional standards and

regulatory & legal requirements and reports issued are appropriate.

3) Its basic objective is that while rendering services, to which engagement standards apply, there should be a system of quality control within firms to ensure complying with professional standards/legal requirements. System of quality control ensures issuing of appropriate reports in the circumstances.
4) Further, it is also to be remembered that Standards on Quality Control (SQCs) are to be applied for all services covered by Engagement Standards.

WHY ARE STANDARDS NEEDED?

1) Standards ensure carrying out of audit against established benchmarks at par with global practices.
2) Standards improve quality of financial reporting thereby helping users to make diligent decisions.
3) Standards promote uniformity as audit of financial statements is carried out following these Standards.
4) Standards equip professional accountants with professional knowledge and skill.
5) Standards ensure audit quality.

DUTIES IN RELATION TO ENGAGEMENT AND QUALITY CONTROL STANDARDS

1) It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them. Ordinarily, these are to be followed by professional accountants. However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement.
2) In such a case, he is required to document how alternative procedures performed achieve the purpose of required procedure. Also, reason for departure has also to be documented unless it is clear. Further, his report should draw attention to such departures.
3) It is also to be noted that a mere disclosure in the report does not absolve a professional accountant from complying with applicable Standards.

Audit Strategy, Audit Planning and Audit Programme

Please refer SA 300 in Module 1 (SA Module)

RISK ASSESSMENT AND INTERNAL CONTROL

UNIT 1 - INTERNAL CONTROL

MEANING OF INTERNAL CONTROL

As per **SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment"**, the internal control may be defined as the process **designed, implemented and maintained** by **those charged with governance, management** and other personnel to provide **reasonable assurance** about the **achievement of an entity's objectives** with regard to:

a) reliability of financial reporting,
b) effectiveness and efficiency of operations,
c) safeguarding of assets, and
d) compliance with applicable laws and regulations.

The term "**controls**" refers to any aspects of one or more of the components of internal control."

GENERAL NATURE AND CHARACTERISTICS OF INTERNAL CONTROL

Purpose of Internal Control

Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

1) The reliability of the entity's financial reporting;
2) The effectiveness and efficiency of its operations;
3) Its compliance with applicable laws
4) and regulations; and
5) Safeguarding of assets.

Note:

The way in which internal control is designed, implemented and maintained **varies with an entity's size and complexity**.

Benefits of Understanding of Internal Control

An understanding of internal control assists the auditor in:

a) Identifying types of potential misstatements.
b) Identifying factors that affect the risks of material misstatement, and
c) Designing the nature, timing, and extent of further audit procedures.

LIMITATIONS OF INTERNAL CONTROL

a) **Internal control can provide only reasonable assurance:**

Internal control, no matter how effective, can provide an entity with **only reasonable assurance** about achieving the entity's financial reporting objectives. The likelihood of their achievement is a ected by inherent limitations of internal control.

b) **Human judgment in decision-making:**

Realities that human judgment in decision-making can be faulty and that **breakdowns** in internal control can occur because of human error.

Example: There may be an error in the design of, or in the change to, a control.

c) **Lack of understanding the purpose:**

Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control **(for example, an exception report)** is not e ectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

d) **Collusion among People:**

Additionally, controls can be circumvented by the **collusion** of two or more people or inappropriate management override of internal control.

For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

e) **Judgements by Management:**

Further, in designing and implementing controls, management may make judgments on **the nature and extent** of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

f) **Limitations in case of Small Entities:**

Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

COMPONENTS OF INTERNAL CONTROL

The division of internal control into the following **five components** provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

A) The control environment.

B) The entity's risk assessment process

C) The information system, including the related business processes, relevant to financial reporting, and communication.

D) Control activities

E) Monitoring of controls.

(A) CONTROL ENVIRONMENT

The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

1) **Management has created and maintained a culture of honesty and ethical behavior; and**

2) **The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.**

What is included in Control Environment?

The **control environment** includes:

a) the **governance and management** functions and

b) the **attitudes, awareness, and actions** of those charged with governance and management.

c) the control environment **sets the tone of an organization**, influencing the control consciousness of its people.

Elements of the Control Environment

Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

a) Communication and enforcement of integrity and ethical values:

(i) The effectiveness of controls **cannot** rise above the integrity and ethical values of the people who **create, administer, and monitor** them.

(ii) Integrity and ethical behaviour are the **product of the entity's ethical and behavioural standards**, how they are communicated, and how they are reinforced in practice.

(iii) The enforcement of integrity and ethical values includes,

For example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.

(iv) The communication of entity policies on integrity and ethical values may include the communication of behavioural standards to personnel through policy statements and codes of conduct and by example.

b) **Commitment to competence:**

Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

c) **Participation by those charged with governance:**

It **includes** attributes of those charged with governance such as their independence from management, their experience and stature, the extent of their involvement and the information they receive and the scrutiny of activities.

d) **Management's philosophy and operating style:**

Management's philosophy and operating style **encompass** a broad range of characteristics.

For example, management's attitudes and actions towards financial reporting- what approach is taken by management in selecting accounting policies, approach in developing accounting estimates etc. Matters such as approach of management to taking and managing business risks, management's attitude towards information processing and accounting function and personnel reflects upon management's philosophy and operating style.

e) **Organisational structure:**

(i) The **framework** within which an entity's activities for achieving its objectives are **planned, executed, controlled, and reviewed**.

(ii) **Establishing** a relevant organisational structure **includes** considering key areas of authority and responsibility and appropriate lines of reporting.

(iii) The appropriateness of an entity's organisational structure **depends**, in part, on its **size and the nature** of its activities.

f) **Assignment of authority and responsibility:**

Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

g) **Human resource policies and practices:**

(i) Policies and practices that relate to, **for example**, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions. Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity.

(ii) **For example**, standards for recruiting the most qualified individuals - with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behaviour - demonstrate an entity's commitment to competent and trustworthy people.

(iii) Training policies that **communicate prospective roles and responsibilities** and include practices such as training schools and seminars illustrate expected levels of performance and behaviour.

(iv) Promotions driven by periodic performance appraisals **demonstrate** the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Existence of a Satisfactory Control Environment-not an Absolute Deterrent to Fraud

1) **The existence** of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud.
2) Conversely, **deficiencies** in the control environment may **undermine** the effectiveness of controls, in particular in relation to fraud.
3) **For example**, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed.
4) The control environment in itself does **not prevent, or detect and correct**, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (**for example**, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

(B) THE ENTITY'S RISK ASSESSMENT PROCESS

1) **The auditor** shall obtain an understanding of whether the entity has a process for:
   a) **Identifying business risks relevant to financial reporting objectives;**
   b) **Estimating the significance of the risks;**
   c) **Assessing the likelihood of their occurrence;**
   d) **Deciding about actions to address those risks.**
2) The entity's risk assessment process **forms the basis** for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement.
3) **Risks can arise or change** due to factor such as new technology, new business models, products or activities, changes in operating environment etc. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

(C) THE INFORMATION SYSTEM, INCLUDING THE RELATED BUSINESS PROCESSES, RELEVANT TO FINANCIAL REPORTING AND COMMUNICATION

The auditor shall obtain an **understanding of the information system**, including the related business processes, relevant to financial reporting, including the following are as:

1) The **classes of transactions** in the entity's operations that are **significant to the financial statements;**
2) The **procedures** by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
3) The **related accounting records, supporting information** and specific accounts in the financial statements that are **used to initiate, record, process and report transactions;**
4) **How the information system captures events and conditions that are significant to the financial statements;**
5) **The financial reporting process used to prepare the entity's financial statements;**
6) **Controls surrounding journal entries.**

Note:

a) An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).
b) Information system should provide qualitative financial information. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
c) The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities.
d) It may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

(D) CONTROL ACTIVITIES

1) The auditor shall obtain an **understanding of control activities relevant to the audit**, which the auditor considers necessary to assess the risks of material misstatement.
2) An audit requires an understanding of **only those control activities** related to **significant class of transactions, account balance, and disclosure** in the financial statements and the assertions which the auditor finds relevant in his risk assessment process.
3) **Control activities are the policies and procedures that help ensure that management directives are carried out.**

4) Control activities relevant to audit generally include
   a) Policies and procedures relating to performance reviews (reviews of actual performance with budgets),
   b) Information processing (for example controls over checking arithmetical accuracy of records, program change controls etc.,),
   c) Physical controls (like controls over physical security of assets) and
   d) Segregation of duties (controls over ensuring that different people are assigned the responsibilities of authorising transactions, recording transactions and maintaining custody of assets)

(E) MONITORING OF CONTROLS

The auditor shall **obtain an understanding** of the **major activities** that the entity uses to **monitor internal control over financial reporting**.

1) **Monitoring of controls Defined:**

   Monitoring of controls is a process to assess the effectiveness of internal control performance over time.

2) **Helps in assessing the effectiveness of controls on a timely basis:**

   It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. It includes considering whether controls are operating as intended and that they are modified as apropriate for change in conditions.

3) **Management accomplishes through ongoing activities, separate evaluations etc.:**

   Management accomplishes monitoring of controls through **ongoing activities, separate evaluations, or a combination of the two**. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

4) **Management's monitoring activities include:**

   Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

ARE ALL CONTROLS RELEVANT TO THE AUDIT?

1) There is a **direct relationship between an entity's objectives and the controls it implements** to provide reasonable assurance about their achievement.
2) The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, **not all of these objectives and controls are relevant to the auditor's risk assessment**.

Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

a) Materiality.

b) The significance of the related risk.

c) The size of the entity.

d) The nature of the entity's business, including its organisation and ownership characteristics.

e) The diversity and complexity of the entity's operations.

f) Applicable legal and regulatory requirements.

g) The circumstances and the applicable component of internal control.

h) The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.

i) Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

CONTROLS OVER THE COMPLETENESS AND ACCURACY OF INFORMATION

1) Controls over the completeness and accuracy of information produced by the entity **may be relevant to the audit if the auditor intends to make use of the information** in designing and performing further procedures.

   For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data.

2) Controls relating to **operations** and **compliance objectives** may also be **relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures**.

INTERNAL CONTROL OVER SAFEGUARDING OF ASSETS

1) Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both **financial reporting and operations objectives**.

2) The auditor's consideration of such controls is **generally limited** to those relevant to the reliability of financial reporting.

   For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit.

3) **Conversely**, safeguarding controls relating to **operations objectives**, such as controls to prevent the excessive use of materials in production, **generally are not relevant to a financial statement audit.**

CONTROLS RELATING TO OBJECTIVES THAT ARE NOT RELEVANT TO AN AUDIT

1) An entity generally has controls relating to objectives that are not relevant to an audit and therefore **need not be considered**.

   For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit.

2) Further, although internal control applies to the entire entity or to any of its operating units or business processes, an **understanding of internal control relating to each of the entity's operating units** and business processes **may not be relevant to the audit**.

3) In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.

NATURE AND EXTENT OF THE UNDERSTANDING OF RELEVANT CONTROLS

1) Evaluating the design of a control involves considering **whether the control**, individually or in combination with other controls, **is capable of e ectively preventing, or detecting and correcting, material misstatements**

2) Implementation of a control means that the **control exists and that the entity is using it**.

3) There is little point in assessing the implementation of a control that is not e ective, and so the **design of a control is considered first**.

4) An **improperly designed control** may represent a **significant deficiency** in internal control.

5) Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

   a) **Inquiring of entity personnel.**

   b) **Observing the application of specific controls.**

   c) **Inspecting documents and reports.**

   d) **Tracing transactions through the information system relevant to financial reporting.**

6) **Inquiry alone, however, is not su cient for such purposes.**

7) Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls.

   For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes.

RISKS THAT REQUIRE SPECIAL AUDIT CONSIDERATION

1) As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk.
2) In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:
   a) Whether the risk is a **risk of fraud**
   b) Whether the **risk is related to recent significant economic, accounting, or other developments** like changes in regulatory environment, etc., and, therefore, requires specific attention;
   c) The **complexity of transactions;**
   d) Whether the risk involves **significant transactions with related parties;**
   e) The **degree of subjectivity in the measurement of financial information** related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
   f) Whether the risk involves **significant transactions that are outside the normal course of business** for the entity, or that otherwise appear to be unusual.

Identifying Significant Risks

a) Significant risks often relate to significant **non- routine transactions or judgmental matters.**
b) Non-routine transactions are transactions that are **unusual, due to either size or nature,** and that therefore occur infrequently.
c) Judgmental matters may include the **development of accounting estimates** for which there is **significant measurement uncertainty.**
d) **Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement.** The auditor assess assertions affected by a significant risk as higher inherent risk.
e) The following are always significant risks:
   (i) **Risks of material misstatement due to fraud**
   (ii) **Significant transactions with related parties that are outside the normal course of business for the entity**

Risks of Material Misstatement – Greater for Significant Non-Routine Transactions

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

a) **Greater management intervention to specify the accounting treatment.**

b) **Greater manual intervention for data collection and processing.**

c) **Complex calculations or accounting principles.**

d) **The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.**

Risks of material misstatement – Greater for Significant Judgmental Matters

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

a) Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.

b) Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

EVALUATION OF INTERNAL CONTROL BY THE AUDITOR

Introduction

a) The examination and evaluation of the internal control system is an **indispensable part** of the overall audit programme.

b) The auditor needs **reasonable assurance that the accounting system is adequate** and that **all the accounting information which should be recorded has in fact been recorded**. Internal control normally contributes to such assurance.

Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

a) whether errors and frauds are likely to be **located in the ordinary course of operations** of the business;

b) whether an **adequate internal control system is in use and operating** as planned by the management;

c) whether an **effective internal auditing department** is operating;

d) whether any **administrative control has a bearing on his work (for example**, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);

e) whether the controls adequately **safeguard the assets;**

f) how far and how **adequately the management is discharging its function** in so far as correct recording of transactions is concerned;

g) **how reliable the reports, records and the certificates to the management can be;**

h) the **extent and the depth of the examination** that he needs to carry out in the di erent areas of accounting;

i) what would be **appropriate audit technique and the audit procedure** in the given circumstances;

j) what are the **areas where control is weak and where it is excessive**; and

k) whether some **worthwhile suggestions** can be given to improve the control system.

Formulate Audit Program after understanding Internal Control

a) The auditor can formulate his entire audit programme **only after** he has had a **satisfactory understanding of the internal control systems and their actual operation.**

b) If he does not care to study this aspect, it is very likely that his audit programme may become **unwieldy and unnecessarily heavy** and the **object of the audit may be altogether lost** in the mass of entries and vouchers.

c) It is also important for him to know **whether the system is actually in operation.**

d) Often, after installation of a system, **no proper follow up** is there by the management to ensure compliance.

e) The auditor, in such circumstances, may be **led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially.**

f) This state of affairs is probably the **worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.**

g) **It would be better if the auditor can undertake the review of the internal control system of client.**

h) This will give him **enough time to assimilate the controls and implications** and will enable him to be **more objective** in the framing of the audit programme.

i) He will also be in a position to bring to the notice of the management the **weaknesses of the system and to suggest measures for improvement.**

j) At a further interim date or in the course of the audit, he may **ascertain how far the weaknesses have been removed.**

k) From the foregoing, it can be concluded that the **extent and the nature of the audit programme is substantially influenced by the internal control system in operation.**

l) In deciding upon a plan of **test checking**, the **existence and operation** of internal control system is of great significance.

m) A **proper understanding of the internal control system** in its content and working also enables an auditor to decide upon the **appropriate audit procedure** to be applied in di erent areas to be covered in the audit programme.

n) In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

o) **For example**, normally the distribution of wages is not observed by the auditor. But if the internal control over wages is so weak that there exists a possibility of dummy workers being paid, the auditor might include observation of wages distribution in his programme in order to find out the workers who do not turn up for receipt of wages.

p) On the other hand, if he is satisfied with the internal control on sales and trade receivables, the auditor can get trade receivables' balances confirmed at almost any time reasonably close to the balance sheet date. But if the control is weak, he may feel that he should get the confirmation exactly on the date of the year closing so that he may eliminate the risk of errors and frauds occurring between the intervening period. Also, he may in that situation, decide to have a large coverage of trade receivables by the confirmation procedure.

EVALUATION OF INTERNAL CONTROL - METHODS

1) A **review of the internal control** can be done by a process of study, examination and evaluation of the control system installed by the management.
2) The **first step involves determination of the control and procedures** laid down by the management.
3) By **reading company manuals, studying organisation charts and flow charts** and by making suitable enquiries from the officers and employees, **the auditor may ascertain the character, scope and efficacy of the control system**.
4) The auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.

SPECIFIC TOOLS TO REVIEW INTERNAL CONTROL SYSTEM

To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

a) **Narrative record;**
b) **Check List;**
c) **Questionnaire; and**
d) **Flow chart.**

The Narrative Record

a) This is a **complete and exhaustive description** of the system as found in operation by the auditor. Actual testing and observation are necessary before such a record can be developed.

b) It may be recommended in cases where **no formal control system is in operation** and would be more suited to small business.

c) **The basic disadvantages of narrative records are:**

(i) **To comprehend the system in operation is quite difficult.**

(ii) **To identify weaknesses or gaps in the system.**

(iii) **To incorporate changes arising on account of reshuffing of manpower, etc.**

Check List

a) This is a **series of instructions and/or questions** which a member of the auditing staff must follow and/or answer.

b) When he completes instruction, he **initials the space against the instruction.**

c) Answers to the check list instructions are usually **Yes, No or Not Applicable**.

d) This is again an on the **job requirement and instructions** are framed having regard to the desirable elements of control.

e) The complete check list is studied by the **Principal/Manager/Senior to ascertain existence of internal control** and evaluate its implementation and effciency.

A few examples of check list instructions are given hereunder:

1) Are tenders called before placing orders?
2) Are the purchases made on the basis of a written order?
3) Is the purchase order form standardised?
4) Are purchase order forms pre-numbered?
5) Are the inventory control accounts maintained by persons who have nothing to do with custody of work, receipt of inventory, inspection of inventory and purchase of inventory?

Internal Control Questionnaire

a) This is a **comprehensive series of questions** concerning internal control.

b) **This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.**

c) An important advantage of the questionnaire approach is that **oversight or omission of significant internal control review procedures is less likely to occur with this method.**

d) With a proper questionnaire, all **internal control evaluation can be completed at one time** or in sections.

e) The review can **more easily** be made on an interim basis.

f) The questionnaire form also provides an **orderly means of disclosing control defects.**

g) It is the general practice to review the internal control system annually and record the review in detail.

h) In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness.

i) Provision is made for an explanation or further details of 'No' answers.

j) In respect of questions not relevant to the business, 'Not Applicable' reply is given.

k) The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees.

l) If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture.

m) The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

Flow Chart

a) It is a graphic presentation of each part of the company's system of internal control.

b) A flow chart is considered to be the most concise way of recording the auditor's review of the system.

c) It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form.

d) It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

e) It is also necessary for the auditor to study the significant features of the business carried on by the concern;

f) The nature of its activities and various channels of goods and materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration.

g) This will help him to understand and evaluate the internal controls in the correct perspective.

TESTING OF INTERNAL CONTROL (TEST OF CONTROLS)

1) After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. For this, he resorts to actual testing of the system in operation. This he does on a selective basis: he can plan this testing in such a manner that all the important areas are covered in a period of, say, three years.

2) **Test of Controls:** Test of controls are performed to obtain audit evidence about the effectiveness of the:

   a) Design of the accounting and internal control systems,

b) Operation of the internal controls throughout the period.

3) Test of controls include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

4) Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control.

For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation.

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

Test of controls may include

a) Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.

b) Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.

c) Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.

d) Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

RELATIONSHIP BETWEEN TEST OF CONTROLS AND SUBSTANTIVE PROCEDURE.

1) While obtaining audit evidence about the effective operation of internal controls, the auditor considers,
   a) How they were applied,
   b) The consistency with which they were applied during the period and
   c) By whom they were applied.

2) The concept of effective operation recognises that some deviations may have occurred.

3) Deviations from prescribed controls may be caused by such factors as changes in key

personnel, significant seasonal fluctuations in volume of transactions and human error.

4) When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions.
5) The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.
6) Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk.
7) The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised.
8) In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.
9) Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed.
10) In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications.
11) Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment.
12) Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

UNIT 2 - AUTOMATED ENVIRONMENT

WHAT IS AN AUTOMATED ENVIRONMENT?

An **automated environment** basically **refers** to a **business environment** where the **processes, operations, accounting and even decisions** are **carried out** by using **computer systems – also known as Information Systems (IS) or Information Technology (IT) systems**. Nowadays, it is very common to see computer systems being used in almost every type of business.

KEY FEATURES OF AN AUTOMATED ENVIRONMENT

1) The fundamental principle of an automated environment is the ability **to carry out business with less manual intervention** and more system driven.
2) The complexity of a business environment **depends on the level of automation** i.e., if a business environment is more automated, it is likely to be more complex.
3) **Key features** of an automated environment are as under: -
   a) Enables faster business operation
   b) Accuracy in data processing and computation
   c) Ability to process large volume of transactions
   d) Integration amongst business operations
   e) Better security and controls
   f) Less prone to human errors
   g) Provides latest information
   h) Connectivity and networking capability
4) If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

UNDERSTANDING AND DOCUMENTING AUTOMATED ENVIRONMENT

a) In an audit of financial statements, an auditor is required to understand the entity and its business, including IT.
b) Understanding the entity and its automated environment **involves** understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.
c) Given below are some of the **points** that an **auditor should consider** to **obtain an understanding** of the company's automated environment:
   (i) Information systems being used (one or more application systems and what they are)
   (ii) Their purpose (financial and non-financial)
   (iii) Location of IT systems - local vs global

(iv) Architecture (desktop based, client-server, web application, cloud based)
(v) Version (functions and risks could vary in different versions of same application).
(vi) Interfaces within systems (in case multiple systems exist).
(vii) In-house vs Packaged.
(viii) Outsourced activities (IT maintenance and support).
(ix) Key persons (CIO, CISO, Administrators).

d) The **understanding** of a company's IT environment that is **obtained** should be **documented**.

RISKS ARISING FROM USE OF IT SYSTEMS

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems.

Given below are some such risks that should be considered:

a) Inaccurate processing of data, processing inaccurate data, or both.
b) Unauthorized access to data.
c) Direct data changes (backend changes).
d) Excessive access / Privileged access (super users).
e) Lack of adequate segregation of duties.
f) Unauthorized changes to systems or programs.
g) Failure to make necessary changes to systems or programs.
h) Loss of data.

IMPACT OF IT RELATED RISKS

The above risks have to be mitigated. If not mitigated, such risks, could have an impact on audit in different ways discussed as under: -

1) **Impact on substantive checking:**

   Inability to address above discussed risks may lead to non-reliance of data obtained from systems. In such a case, all information, data, and reports would have to be tested thoroughly for their completeness and accuracy. It could lead to increased substantive checking i.e., detailed checking.

2) **Impact on controls:**

   It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications. It may result in additional audit work.

3) **Impact on reporting:**

   Due to regulatory requirements in respect of internal financial controls (discussed in subsequent paras) in case of companies, it may lead to modification of auditor's report in some instances.

TYPES OF CONTROLS IN AN AUTOMATED ENVIRONMENT

Controls in an automated environment can be categorized as under: -

(A) General IT controls

(B) Application controls

(C) IT-dependent controls

(A) GENERAL IT CONTROLS

1) **General IT controls** are **policies and procedures** that **relate** to many applications and support the effective functioning of application controls.
2) General IT-controls that **maintain the integrity** of information and security of data commonly **include controls over the following**:
   a) Data centre and network operations
   b) Program change
   c) Access security
   d) Application system acquisition, development, and maintenance (Business Applications)
3) These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, **General IT controls are known as "pervasive" controls or "indirect" controls**.

a) Controls over Data centre and network operations

(i) The objective of controls over Data centre and network operations is to ensure that production systems are processed to meet financial reporting objectives.

(ii) These include activities such as
- overall management of computer operation activities,
- preparing, scheduling and executing of batch jobs,
- monitoring, storage and retention of backups.

(iii) Such controls also help in performance monitoring of operating system, database and networks.

(iv) Matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan) which deal with recovery from failures are also taken care of by such type of controls.

b) Program Change

(i) The objective of program change controls is to ensure that modified systems continue to meet financial reporting objectives.

(ii) It includes activities such as change management process, recording, managing and tracking change requests, making and testing changes etc.

c) <u>Access Security</u>

(i) The objective of controls over access security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

(ii) It includes activities such as security organization & management, security policies & procedures, application security, data security, operating system security, network security, physical security etc.

d) <u>Application system acquisition, development, and maintenance</u>

(i) The objective of such controls is to ensure that systems are developed, configured and implemented to meet financial reporting objectives.

(ii) It includes overall management of development activities, project initiation, analysis & design, construction, testing & quality assurance etc.

(B) APPLICATION CONTROLS

1) Application controls **include** both **automated or manual controls** that operate at a business process level.
2) Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.
3) **Examples** of automated applications include edit checks and validation of input data, sequence number checks, user limit checks, reasonableness checks, mandatory data fields.

(C) IT DEPENDENT CONTROLS

1) IT dependent controls are basically **manual controls** that make use of some form of data or information or report produced from IT systems and applications.
2) In this case, even though the control is performed manually, the **design and effectiveness** of such controls **depends on the reliability of source data**.
3) Due to the inherent dependency on IT, the effectiveness and reliability of automated application controls and IT dependent controls require the General IT controls to be effective.

GENERAL IT CONTROLS VS. APPLICATION CONTROLS

These two categories of control over IT systems are interrelated. The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

TESTING METHODS IN AN AUTOMATED ENVIRONMENT

1) There are basically **four types of audit tests** that should be used. These are
   a) **Inquiry,**
   b) **Observation,**
   c) **Inspection and**
   d) **Reperformance.**
2) **Inquiry is the most efficient audit test** but it also **gives** the **least audit evidence**. Hence, **inquiry should always be used in combination** with any one of the other audit testing methods. Inquiry alone is not sufficient.
3) **Reperformance is most effective** as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.
4) Generally, applying **inquiry in combination with inspection gives the most effective and efficient** audit evidence.
5) However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including:
   a) Risk assessment,
   b) Control environment,
   c) Desired level of evidence required,
   d) History of errors/misstatements,
   e) Complexity of business,
   f) Assertions being addressed etc.
6) **The auditor should document** the **nature of test** (or combination of tests) applied along with the **judgements** in the audit file. When testing in an automated environment, some of the more common methods are as follows:
   a) **Obtain an understanding** of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
   b) **Observe** how a user processes transactions under different scenarios.
   c) **Inspect** the configuration defined in an application.
7) Where the general IT controls are **not existing or existing but ineffective**, the auditor should **assess the impact of IT risks and complexity of the automated environment** in which the business operations take **place and plan alternative audit procedures** in order **to rely** on the system-based information.

CHARACTERISTICS OF MANUAL AND AUTOMATED ELEMENTS OF INTERNAL CONTROL RELEVANT TO THE AUDITOR'S RISK ASSESSMENT

1) An entity's system of internal control **contains** manual elements and often contains automated elements.
2) The **characteristics** of manual or automated elements are **relevant** to the **auditor's risk assessment** and **further audit procedures** based thereon.
3) The use of manual or automated elements in internal control also affects the manner in which transactions are **initiated, recorded, processed, and reported**:
   a) **Controls** in a manual system may **include** such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
   b) **Controls** in IT systems **consist of a combination of automated controls** (for example, controls embedded in computer programs) and **manual controls**. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions

MANUAL ELEMENTS VS AUTOMATED ELEMENTS IN ENTITY'S INTERNAL CONTROL

1) **Manual elements** in internal control may be **more suitable** where judgment and discretion are required such as for the following circumstances:
   a) Large, unusual or non-recurring transactions.
   b) Circumstances where errors are difficult to define, anticipate or predict.
   c) In changing circumstances that require a control response outside the scope of an existing automated control.
   d) In monitoring the effectiveness of automated controls.
2) **Manual elements** in internal control may be **less reliable** than automated elements because they can be **more easily bypassed, ignored, or overridden** and they are also more prone to simple errors and mistakes.
3) Consistency of application of a manual control element **cannot** therefore be assumed. Manual control elements may be **less suitable for the following circumstances**:
   a) **High volume or recurring transactions**, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
   b) Control activities where the **specific ways** to perform the control can **be adequately**

designed and automated.

4) The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system.

5) The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

AUDIT APPROACH IN AN AUTOMATED ENVIRONMENT

Risk Assessment	Understand and Evaluate	Test for Operating Effectiveness	Reporting
a) Identify significant accounts and disclosures b) Qualitative and Quantitative considerations c) Relevant Financial Statement Assertions (FSA) d) Identify likely sources of mistatement e) Consider risk arising from use of IT systems	a) Document understanding of business processess using Flowcharts / Narratives b) Prepare Risk and Control Matrices (RCM) c) Understand design of controls by performing walkthroughs of end-to-end process d) Process wide considerations for Entity Level Controls, Segregation of Duties e) IT General Controls, Application Controls	a) Assess Nature, Timing and Extent (NTE) of controls testing b) Assess reliability of source data: completeness of population c) Testing of key reports and spreadsheets d) Sample testing e) Consider competence and independence of staff/team performing controls testing.	a) Evaluate Control Deficiencies b) Significant deficiencies, Material Weaknesses c) Remediation of control weaknesses d) Internal Controls Memo (ICM) or Management Letter e) Auditor's report

DATA ANALYTICS FOR AUDIT

1) In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous.

2) The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics.

3) While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results.

4) The **tools and techniques** that auditors use in applying the principles of data analytics are known as **Computer Assisted Auditing Techniques or CAATs** in short.

5) **Data analytics** can be **used** in **testing of electronic records and data residing** in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

   a) **Check completeness** of data and population that is used in either test of controls or substantive audit tests.

   b) **Selection of audit samples** - random sampling, systematic sampling.

   c) **Re-computation of balances** - reconstruction of trial balance from transaction data.

   d) **Reperformance of mathematical calculations** - depreciation, bank interest calculation. Analysis of journal entries

   e) **Fraud investigation.**

   f) **Evaluating** impact of control deficiencies.

DIGITAL AUDIT

1) Entities are **embracing digitization** as part of their operations **to keep pace with changing times**. New technologies are helping companies revamp their operations and rethink the way business is conducted.

2) Companies are restructuring their business models driven by technology. **Automation is key to digitization.**

3) In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion.

4) **Auditors** are making use of artificial intelligence, data analytics and other latest technologies **to help understand business processes** in a better way.

5) By using such tools, **auditors** can **conduct audit** in a **better way** and devote more attention to areas requiring greater focus.

6) **Digital audit is helping auditors** to better identify risks making use of technology.

INTERNAL FINANCIAL CONTROLS AS PER REGULATORY REQUIREMENTS

The term Internal Financial Controls (IFC) basically **refers to the policies and procedures** put in place by companies for ensuring:

a) **Reliability of financial reporting**

b) **Effectiveness and efficiency of operations**

c) **Compliance with applicable laws and regulations**

d) **Safeguarding of assets**

e) **Prevention and detection of frauds**

The Companies Act, 2013 has placed a greater emphasis on the effective implementation and reporting on the internal controls for a company.

The term "internal financial controls" is used at some places in Companies Act, 2013 casting responsibilities as under: -

Relevant provision of Companies Act,2013	Nature of Responsibility
Section 134 (5)(e)	In case of listed Companies, the Directors' responsibility statement shall state that the Directors had laid down Internal financial controls to be followed by the company and that such Internal financial controls are adequate and were operating effectively.
Section 143(3) (i) of the Act	The auditor's report shall state whether the company has adequate Internal financial controls system in place and also on the operating effectiveness of such controls. This requirement shall not apply to a private company which - (i) is One Person Company or a small company; or (ii) has turnover less than ₹ 50 crore as per latest audited Financial Statements; and which has aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial Year for less than ₹ 25 crore.
Section177(4) (vii) of the Act	Every audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include - evaluation of internal financial controls and risk management systems.
As per Section 149(8) of the Act	The company and independent directors shall abide by the provisions specified in Schedule IV which lays down the Code for independent Directors. As per this code, the role and functions of independent directors include that they shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.

The directors and management have primary responsibility of implementing and maintaining an effective internal controls framework and auditors are expected to evaluate, validate and report on the design and operating effectiveness of internal financial controls.

ASSESS AND REPORT AUDIT FINDINGS

1) At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee.
2) **Some points to consider are as follows**:
   a) Are there any weaknesses in IT controls?
   b) What is the impact of these weaknesses on overall audit?
   c) Report deficiencies to management - Internal controls memo or Management letter.
   d) Communicate in writing any significant deficiencies to those Charged with governance.
3) The auditor **needs to assess** each finding or exception **to determine impact** on the audit and evaluate if the exception results in a deficiency in internal control.
4) A **deficiency** in internal control **exists** if a **control is designed, implemented or operated** in such a way that it is u**nable to prevent, or detect and correct, misstatements** in the financial statements on a timely basis; or the control is missing.
5) **Evaluation and assessment** of audit findings and control deficiencies **involves applying professional judgement** that include considerations for quantitative and qualitative measures. Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

Audit Evidence

Please refer SA 500, 501, 505, 510, 520, 530, 550, 610 in Module 1 (SA Module)

AUDIT OF ITEMS OF FINANCIAL STATEMENT

INTRODUCTION

INTRODUCTION

1) Companies prepare their financial statements in accordance with the framework of **generally accepted accounting principles (Indian GAAP)**, also commonly referred to as **accounting standards or financial reporting standards (Ind AS)**.
2) A **financial statement audit** comprises the examination of an entity's **financial statements** and accompanying disclosures by an independent **auditor**. The result of this examination is a report by the auditor, attesting to the truth and fairness of presentation of the **financial statements** and related disclosures.

ASSERTION

It refers to the **representations by management**, explicit or otherwise, that are **embodied in the financial statements**, as used by the auditor to consider the di erent types of **potential misstatements that may occur**.

In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding

a) The completeness,
b) Cut-offs
c) Existence / occurrence,
d) Valuation / measurement,
e) Rights and obligations and
f) Presentation and disclosure

of **Assets, Liabilities, Equity, Income, Expenses and Disclosures** in accordance with the applicable financial reporting standards / accounting standards.

Example:

If Company X's balance sheet shows building with carrying amount of ` 50 lakh, the auditor shall assume that the management has claimed / asserted that:

a) The building recognized in the balance sheet exists as at the period- end (existence assertion);
b) Company X owns and controls such building (Rights and obligations assertion);
c) The building has been valued accurately in accordance with the measurement principles (Valuation assertion);
d) All buildings owned and controlled by Company X are included within the carrying amount of ` 50 lakh (Completeness assertion).
e) The auditor then needs to draw an audit programme to verify and obtain su cient and appropriate audit evidence for each of the above claims / assertions made by the management.

The auditor then needs to **draw an Audit Programme** to verify the assertions made by the management by obtaining sufficient and appropriate audit evidence for each of the claims made on **Account Balances, Class of Transactions and Related Disclosures.**

ASSERTIONS MAY BE BROADLY CLASSIFIED INTO THE FOLLOWING TYPES

Income Statement Captions Comprising Revenue and Expense Balances

Assertions	Explanation	Example: Employee benefit expenses & Sales
Occurrence	Transactions recognized in the financial statements have occurred and relate to the entity.	a) Employee benefit expense has been incurred during the period in respect of the personnel employed by the entity. b) Employee benefit expense does not include the cost of any unauthorized personnel. c) Recorded Sales represent goods which were ordered by valid customers and were dispatched and invoiced in the period.
Completeness	a) All transactions that were supposed to be recorded have been recognized in the financial statements. b) Transactions have not been omitted.	a) Employee benefit expenses in respect of all personnel have been fully accounted for. b) All the genuine Sales have been recorded.
Cut-off	a) Whether all income and expenses are reported in the correct accounting period. b) Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness.	a) Employee benefit expenses recognized during the period relates to the current accounting period only. b) Sales shall include the dispatch of goods made at the year-end as they belong to the relevant period.

Measurement	a) Transactions have been recorded accurately at their appropriate amounts in the financial statements. b) There have been no errors while preparing documents or in posting transactions to ledger. c) The figures and explanations are not misstated.	a) Employee benefit expense has been measured / calculated accurately. b) Any adjustments such as tax deduction at source have been correctly reconciled and accounted for. c) Sales are recorded correctly in the books based on the invoices. Discounts have been properly adjusted or accounted for.
Presentation and Disclosure	a) Transactions have been classified and presented fairly in the financial statements. b) Transactions and Events are appropriately segregated or disaggregated. c) Presentation and disclosure assertions are considered during the course of the audit by procedures to determine that disclosures are **complete and accurate**. d) The disclosures that are **most susceptible to material misstatement** are those that require significant judgment and qualitative assessments. e) Audit teams **assess the completeness and accuracy** of disclosures by determining that the disclosures provide **information in a manner that does not materially omit, distort or mislead the user**. f) The description and disclosure of transactions are **relevant and easy to understand**.	a) A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items: Employee Benefits Expense (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses]. b) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from— (a) Sale of products; (b) Sale of services; (ba) Grants or donations received (relevant in case of section 8 companies only),] (c) Other operating revenues; Less: (d) Excise duty

Balance Sheet Captions Comprising Assets, Liabilities and Equity Balances

Assertions	Explanation	Example: Employee benefit expenses & Sales
Existence	Assets, liabilities and equity balances exist as at the period end.	Inventory recognized in the balance sheet actually existed as at the period end.
Completeness	All assets, liabilities and equity balances that were supposed to be recorded have been recognized in the financial statements.	a) All inventory units held by the audit entity and that should have been recorded, have been recognized appropriately in the financial statements. b) Any inventory held by a third party on behalf of the entity has been included as part of the inventory balance Inventory held by the entity as a Consignee (on behalf of third party i.e. Consignor) shall be excluded.
Cut-off	Whether all assets and liabilities are reported in the appropriate period.	a) Inventory balance as at the year-end does not include any element of next financial year. b) All items of inventory pertaining to the relevant year shall be included regardless of the location.
Valuation	a) Assets, liabilities and equity balances have been valued appropriately i.e. the amounts at which they are recorded are appropriate. b) There has been no overstatement or understatement.	a) Inventory has been recognized at the **lower of cost and net realizable** value in accordance with **AS 2- Inventories**. b) Any costs that **could not be reasonably allocated** to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been

		excluded from the cost of inventory. c) An acceptable valuation basis (e.g. FIFO, Weighted average etc.) has been used to value inventory cost as at the period-end
Rights & Obligations	Entity has the right to assets i.e. (whether the entity has ownership and title to assets) and the liabilities recognized in the financial statements represent all the entity's obligations to repayment at a given date.	a) The entity owns or controls the inventory recorded in the financial statements i.e. the purchase invoices have been made in the name of client. b) Any inventory held by the entity on behalf of another entity has not been recognized as part of inventory of the entity. (Example: Consignment agreements can be checked)
Presentation and Disclosure	a) Whether particular items in the financial statements are properly **classified, described and disclosed**. b) Presentation and disclosure assertions are considered during the course of the audit to determine that disclosures are **complete and accurate**. c) The disclosures that are most susceptible to material misstatement are those that require significant judgment and qualitative assessments. d) Audit teams assess the completeness and accuracy of disclosures by determining that the disclosures provide information in a manner that does not materially omit, distort or mislead the user. e) The balances have been appropriately segregated or disaggregated.	**Example 1** Inventories (i) Inventories shall be classified as: a) Raw materials; b) Work-in-progress; c) Finished goods; d) Stock-in-trade (in respect of goods acquired for trading); e) Stores and spares; f) Loose tools; g) Others (specify nature). (ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories. (iii) Mode of valuation shall be stated. **Example 2:** For Share capital, a reconciliation of the number of shares outstanding at the beginning and at the end of the

	f) The related disclosures are Understandable in accordance with applicable Financial Reporting framework.	reporting period is required to be disclosed in the notes to accounts of the company.

ASSERTIONS AS PER SA 315

Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:

1) Assertions about classes of transactions and events for the period under audit:
   a) **Occurrence** - transactions and events that have been recorded have occurred and pertain to the entity.
   b) **Completeness** - all transactions and events that should have been recorded have been recorded.
   c) **Accuracy** - amounts and other data relating to recorded transactions and events have been recorded appropriately.
   d) **Cut-off** - transactions and events have been recorded in the correct accounting period.
   e) **Classification** - transactions and events have been recorded in the proper accounts.

2) Assertions about account balances at the period end:
   a) **Existence** - assets, liabilities, and equity interests exist.
   b) **Rights and obligations** - the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
   c) **Completeness** - all assets, liabilities and equity interests that should have been recorded have been recorded.
   d) **Valuation and allocation** - assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

3) **Assertions about presentation and disclosure:**
   a) **Occurrence and rights and obligations** - disclosed events, transactions, and other matters have occurred and pertain to the entity.
   b) **Completeness** - all disclosures that should have been included in the financial statements have been included.
   c) **Classification and understandability** - financial information is appropriately presented and described, and disclosures are clearly expressed.

d) **Accuracy and valuation** - financial and other information are disclosed fairly and at appropriate amounts.

Summary

Class of Transactions (Profit and Loss)	Account Balances (Balance Sheet)	Presentation & Disclosure (Notes to Accounts)
a) Occurrence b) Completeness c) Accuracy d) Cut-off e) Classification	a) Existence b) Rights & Obligations c) Completeness d) Valuation & Allocation	a) Occurrence & Rights & Obligations b) Completeness c) Classification & Understandability d) Accuracy & Valuation

NEGATIVE ASSERTION

Negative assertions are also encountered in the financial statements and the same may be expressed or implied.

For example, if it is stated that there is **no contingent liability it would be an expressed negative assertion**; on the other hand, if in the balance sheet there is **no item as "building"**, it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

Every financial statement contains an overall representation in addition to the specific assertions so far discussed. Each financial statement purports to present something as a whole in addition to its component details.

For example, an income statement purports to present "the results of operations" a balance sheet purports to present "financial position". The auditor's opinion is typically directed to these overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions, expressed and implied, both positive, and negative, that makes up each of these statements.

Out of his individual judgments of these specific assertions he arrives at a judgement on the financial statement as a whole.

BALANCE SHEET CAPTIONS [LIABILITIES]

SHARE CAPITAL

The below table summarizes the audit procedures generally required to be undertaken while auditing share capital:

Assertions	Explanation
Existence	To establish the existence of share capital as at the period- end.
Completeness	Equity balances that were supposed to be recorded have been recognized in the financial statements.
Valuation	Equity balances have been valued appropriately.
Presentation and Disclosure	Required disclosures for equity have been appropriately made

Audit Procedure

1) **Tally the period- end share capital** balance- authorised, issued and paid up, to the **previous year audited financial statements**.
2) In case there in no change during the year, **obtain a written confirmation/ representation** from the Company Secretary that there were no changes to entity's capital structure during the year
3) In case there is any change, verify whether the paid up capital as at the period-end is within the **limits of authorised capital**, which can be verified by examining MOA.
4) **Obtain the certified copies of relevant resolutions passed** at the meetings of board of directors, shareholders authorising the increase / decrease in authorised share capital, if required, or paid up share capital.
5) In case of Fresh issue made in the current year, check with compliance of Companies Act 2013 with regard to **Return of Allotment, Minimum Subscription, minimum application money to be collected, maintenance of separate Bank account, payment of underwriting commission** as per Sec 40 etc.
6) No shares have been **issued at Discount (Sec. 53 of Companies Act)**
7) Check if Shares are issued for cash or for Consideration other than cash. (E.g.: To promoters for their services, underwriters for commission payable to them etc.)
8) Compliance with SEBI regulations and Guidelines.
9) Also, **obtain and verify copies** of forms filed with **Ministry of Corporate Affairs (MCA)** (**Form SH-7**, notice to Registrar of any alteration of share capital, **Form PAS 3** company making allotment of shares/ securities required to file a return of allotment to the Registrar) and with Reserve Bank of India (**Form FCGPR** in case of Foreign Direct Investment (FDI) by a Non-resident shareholder) and verify the number of securities issued along with the issue price.
10) In case there was increase in share capital, verify whether the Company **has accurately calculated the required fee and stamp duty payable to MCA**.

Shares Issued at Premium

1) In case a company has issued shares at a premium, that is, at **amount in excess of the nominal value of the shares**, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the purpose in which the amount in the account can be applied.
2) There is no restriction or conditions prescribed in the Act for issue of shares at premium.
3) The provisions of this Act relating to **reduction of share capital of a company shall apply** as if the securities premium account were the paid- up share capital of the company.

Application of securities premium account:

The securities premium account may be applied by the Company for the following purposes:

a) **towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;**
b) **in writing off the preliminary expenses of the Company;**
c) **in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;**
d) **in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or**
e) **for the purchase of its own shares or other securities under section 68.**

Prescribed Class of Companies are permitted to apply Securities Premium Account:

The securities premium account may be applied by such class of companies, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under Section 133:

a) in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares; or
b) in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company; or
c) for the purchase of its own shares or other securities under section 68.

The auditor needs to verify -

a) **whether the premium received on shares**, if any, has been transferred to a "securities premium account" and
b) **whether the application** of any amount out of the said "securities premium account" is only for the purposes mentioned above.

Shares Issued at discount

According to **section 53** of the Companies Act, 2013,

1) A company **shall not issue shares at a discount**, **except** in the case of an **issue of sweat equity shares** given under **Section 54** of the Companies Act, 2013.
2) Any share issued by a company at a **discounted price shall be void.**
3) Where any **company fails to comply with the provisions of this section**, such company and every officer who is in default shall be liable to a **penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less**, and the company shall also be **liable to refund all monies received with interest** at the rate of **twelve per cent per annum** from the date of issue of such shares to the persons to whom such shares have been issued.

Note:

2A) Notwithstanding anything contained in sub- sections 1) and 2), a company may issue shares at a discount **to its creditors** when its **debt is converted into shares** in pursuance of any statutory **resolution plan or debt restructuring scheme** in accordance with any guidelines or directions or regulations specified by the **Reserve Bank of India** under the Reserve Bank of India Act, 1934 or the **Banking (Regulation) Act, 1949**.

The auditor needs to check

a) **The movement in share capital during the year** and wherever there is any issue,
b) He should **verify that the Company** has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.
c) Further, auditor should also verify that whether the company has issued shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

Issue of Sweat Equity Shares

According to **section 54** of the Companies Act, 2013, the employees may be compensated in the form of **'Sweat Equity Shares"**.

"Sweat Equity Shares" mean equity shares issued by the company to employees or directors at a

a) discount or
b) for consideration other than cash

for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

Refer **Companies Act, 2013 Section 54** for explanation.

The auditor needs to verify that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions have been complied with:

a) The issue is authorised by a **special resolution** passed by the company;

b) The resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

c) **omitted**

d) Where the equity shares of the company are **listed on a recognised stock exchange**, the sweat equity shares are issued **in accordance with the regulations made by the Securities and Exchange Board** in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

e) The rights, limitations, restrictions and provisions as are **for the time being applicable to equity shares** shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank **pari passu** with other equity shareholders.

Reduction of Capital

For verifying reduction of capital, the auditor needs to examine whether the company has followed the **specific requirements as required by Sec 66** of the Companies Act, 2013. The auditor shall undertake the following audit procedures:

1) Verify that the **meeting of the shareholder held to pass the special resolution** was properly convened and that the proposal was circularized in advance to all the shareholders;

2) Verify that the **Articles of Association authorises reduction of capital;**

3) **Examine that there has been no default w.r.t repayment of deposits accepted by company or payment of interest on such deposits. Reduction of capital shall not be affected if such default exists.**

4) Examine the **order of the Tribunal confirming the reduction** and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies;

5) **Check the Registrar's Certificate** as regards to reduction of capital;

6) **Vouch the accounting entries recorded to reduce the capital** and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also check whether the requirements of Schedule III, Part I, have been complied with; in relation to presentation;

7) Confirm **whether the revaluation of assets** has been properly disclosed in the Balance Sheet;

8) The company may reduce the capital by reduction in unpaid capital or cancellation of lost capital or paying of excess paid up capital. Verify the **adjustment made in the members' accounts** in the Register of Members and confirm that either the paid up amount shown on the old share certificates has been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled;

9) Confirm that the words **"and reduced"**, if required by the order of the Tribunal, have **been**

added to the name of the company in the Balance Sheet.

10) Check if the company have complied with all the terms and conditions imposed by the tribunal while confirming reduction of share capital.
11) Verify that the Memorandum of Association of the company has been suitably altered.

Note:

Exemption to Buy-Back: According to Section 66 (6), nothing in this section shall apply to buyback of its own securities by a company under Section 68.

If the Company has made any buyback of securities, ensure compliance of specific requirements as given under section 68 of Companies Act 2013.

Presentation & Disclosure

Ensure whether the following disclosure requirements of Schedule III (Part 1) to Companies Act, 2013 have been complied with:

Share Capital

For each class of share capital (different classes of preference shares to be treated separately):

a) The number and amount of shares authorised;
b) The number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
c) Par value per share;
d) A reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;
e) The rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
f) Shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;
g) Shares in the company held by each shareholder holding more than 5 per cent. shares specifying the number of shares held;
h) Shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;
i) For the period of five years immediately preceding the date as at which the Balance Sheet is prepared:
    (i) Aggregate number and class of shares allotted as fully paid-up pursuant to contract(s) without payment being received in cash.
    (ii) Aggregate number and class of shares allotted as fully paid-up by way of bonus shares.
    (iii) Aggregate number and class of shares bought back.
j) Terms of any securities convertible into equity/preference shares issued along with the

earliest date of conversion in descending order starting from the farthest such date;

k) Calls unpaid (showing aggregate value of calls unpaid by Directors and officers);

l) Forfeited shares (amount originally paid-up).

m) A company shall disclose Shareholding of Promoters* as below:

Shares held by promoters at the end of the year				% Change during the year **
S. No.	Promoter Name	No. of shares	% of total shares**	

Promoter here means promoter as defined in the Companies Act, 2013.

** Details shall be given separately for each class of shares

*** Percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.]

**** Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilised amounts have been used or invested.

NOTE 1: UTILISATION OF BORROWED FUNDS AND SHARE PREMIUM

A. Where company has advanced or loaned or invested funds (either borrowed funds or share premium or any other sources or kind of funds) to any other person(s) or entity(ies), including foreign entities (Intermediaries) with the understanding (whether recorded in writing or otherwise) that the Intermediary shall

a) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company (Ultimate Beneficiaries) or

b) provide any guarantee, security or the like to or on behalf of the Ultimate Beneficiaries;

the company shall disclose the following:

(i) date and amount of fund advanced or loaned or invested in Intermediaries with complete details of each Intermediary.

(ii) date and amount of fund further advanced or loaned or invested by such Intermediaries to other intermediaries or Ultimate Beneficiaries along with complete details of the ultimate beneficiaries.

(iii) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(iv) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).;

B. **Where a company has received any fund from any person(s) or entity(ies), including foreign entities (Funding Party) with the understanding (whether recorded in writing or otherwise) that the company shall**

a) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party (Ultimate Beneficiaries) or

b) provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries, the company shall disclose the following:-

(i) date and amount of fund received from Funding parties with complete details of each Funding party.

(ii) date and amount of fund further advanced or loaned or invested other intermediaries or Ultimate Beneficiaries along with complete details of the other intermediaries or ultimate beneficiaries.

(iii) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(iv) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).]

RESERVE AND SURPLUS

1) Reserves are **amounts appropriated out of profits** that are not intended

a) to meet **any liability,**

b) **contingency,**

c) **commitment or**

d) **diminution in the value of assets** known to exist as at the date of the Balance Sheet.

2) Reserves are a vital source of financing by internal means. The company utilizes the reserves according to the nature and type of such reserve. The reserves can be segregated as revenue or capital reserves.

3) **Revenue reserves** represent profits that are available for distribution to shareholders or below purposes such as:

a) To supplement divisible profits in lean years,

b) To finance an extension of business

c) To augment the working capital of the business or

d) To generally strengthen the company's financial position.

5) **Capital Reserve** represents a reserve which **does not include any amount regarded as free for distribution**.

   Examples: Securities premium, capital redemption reserve.

6) It may be noted that if a company appropriates revenue profit for being credited to the **asset replacement reserve** with the objective that these are to be used for a capital purpose, such a reserve shall also be in the **nature of a capital reserve**.

7) Capital Reserve is created from capital profits earned through sale of capital assets such as sale of fixed assets, profit on sale of shares.

8) A capital reserve, generally, can be **utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realized**.

9) But the amount of securities premium or capital redemption reserve account can be utilised only for the purposes specified in Sections 52 and 55 of the Companies Act, 2013, respectively.

The below table summarises the audit procedures generally required to be undertaken while auditing reserves and surplus / other equity:

Assertions	Explanation
Existence	To establish the existence of reserves and surplus as at the period- end
Completeness	Reserves and Surplus balances that were supposed to be recorded have been recognized in the financial statements.
Valuation	Reserves and Surplus balances have been valued appropriately.
Presentation and Disclosure	Required disclosures for reserves and surplus have been appropriately made

AUDIT PROCEDURES

Trace and tally the **opening balance of reserves and surplus** to the previous year audited financial statements. For addition / utilization in current year, in case of:

Profit and Loss balance

1) Trace the **movement to surplus/ deficit** as per the Statement of profit and loss for the year under audit.
2) The movement should be **traced in the Statement of Changes in Equity**.
3) Verify the **resolution passed by the board of directors** regarding the recommendation of dividend, resolution passed by shareholders declaring the dividend.
4) Students should note that as per **AS-4 (revised) or IND AS 10**, if dividends to holders of equity instruments are **proposed or declared after the balance sheet date**, an entity should

not recognize those dividends as a liability as at the balance sheet date.

5) It should, however, disclose the amount of dividends that were proposed or declared after the balance sheet date, but before the financial statements were approved for issue.

Securities Premium

1) It needs to be confirmed that company has issued shares in excess of the nominal value of the shares and for the same, the auditor should obtain and verify the resolution passed by the board of directors.
2) As already discussed under the caption - 'share capital', the utilisation of securities premium account could be done only for limited purposes; auditor needs to ensure that same.
3) Refer Companies Act, 2013 for explanation of this section.

Presentation & Disclosure

1) **Ensure whether the following disclosure requirements of Schedule III (Part 1) to Companies Act, 2013 have been complied with:**

a) **Reserves and Surplus shall be classified as:**

(i) Capital Reserves;

(ii) Capital Redemption Reserve;

(iii) Securities Premium [Omitted];

(iv) Debenture Redemption Reserve;

(v) Revaluation Reserve;

(vi) Share Options Outstanding Account;

(vii) Other Reserves- (specify the nature and purpose of each reserve and the amount in respect thereof);

(viii) Surplus i.e., balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/ from reserves, etc.; (Additions and deductions since last balance sheet to be shown under each of the specified heads);

b) **A reserve specifically represented by earmarked investments shall be termed as a "fund".**

c) **Debit balance of statement of profit and loss shall be shown as a negative figure under the head "Surplus". Similarly, the balance of "Reserves and Surplus", after adjusting negative balance of surplus, if any, shall be shown under the head "Reserves and Surplus" even if the resulting figure is in the negative.**

BORROWINGS

Liabilities are the **financial obligations of an enterprise other than owners' funds**. Liabilities include loans / borrowings, trade payables and other current liabilities, deferred payment credits and provisions.

Verification of liabilities is as important as that of assets, for, if any liability is omitted (or understated) or overstated, the Financial statement would not show a true and fair view of the state of affairs of the company.

Borrowings are monies made available using external sources like bank loans, debentures, public fixed deposits etc.

The below table summarizes the audit procedures generally required to be undertaken while auditing borrowings:

Assertions	Explanation
Existence	All borrowings on the balance sheet represent valid claims by banks or other third parties.
Completeness	That all borrowings have been accounted for in the books of the company on a timely basis.
Valuation	That liability is recorded at the correct amount.
Presentation and Disclosure	That borrowings have been presented, classified and disclosed in the financial statements in accordance with the requirements of applicable financial reporting framework i.e. Companies Act, 2013 and applicable Indian GAAP

Existence

1) **Review board minutes** for approval of new lending agreements.
2) During review, ensure that new loan agreements or bond issuances were **authorized.**
3) Ensure that **significant debt commitments** were approved by the board of directors.
4) **Agree details of loans recorded** (interest rate, nature and repayment terms) to the loan agreement. **Verify that borrowing limits, if any, imposed by agreements are not exceeded.**
5) **Roll out and obtain independent balance confirmations** in respect of all the borrowings from the lender (banks/ financial institutions etc.).
6) **Agree details of leases and hire purchase creditors** recorded to underlying contracts / agreements.
7) **In case of Debenture, examine trust deed** for terms and dates of redemption, borrowing restrictions and compliance with covenants.

8) When debt is retired, ensure that a discharge is received on assets securing the debt.
9) Obtain Written Representation that all the liabilities which have been recorded represent a valid claim by the lenders.

Completeness

1) Obtain a schedule of short term and long-term borrowing (including debt outstanding at the end of the previous year, as well as any new debt or renewal of debt) showing beginning and ending balances and borrowings taken and repaid during the year, and perform the following:
   a) Consider any evidence of additional debt obtained through examination of minutes of the board of directors, significant contracts, confirmations from banks/ lenders, support for subsequent cash disbursements (when testing payables) etc.
   b) Trace the closing balances as per the schedules to the general ledger.
2) Review subsequent transactions after the end of the reporting period to determine if there are unrecorded liabilities at year-end and the transactions are recorded in the correct period.

Direct confirmation procedures

Roll out and obtain independent balance confirmations in respect of all the borrowings from the lender (banks / financial institutions etc.) and perform the following:

a) Ascertain that the confirmation asks for all information likely to be relevant to the tests of debt and related interest balances (e.g., applicable interest rates, due dates, the date to which interest has been paid, collateral and security interests).
b) Send reminders for non-replies.
c) Compare the balances are per the confirmations obtained to the books of the accounts. Ask for reconciliations, if there are any differences and test the supporting documents for the reconciling items on a test check basis.

Valuation

1) Determine that the accounting policies and methods of recording debt are appropriate and applied consistently.
2) Agree loan balance and loan payables to the loan agreement.
3) Recompute the interest, and discount or premium on redemption.
4) Check computation of the amortization of premium or discount, if any.
5) For foreign currency loans, check the closing exchange rate(s) used and verify the computations of the restatements of foreign currency balances outstanding at year end. (As per AS 11).

Other Procedures

1) Read the provisions in loan and debt agreements and perform the following:

a) Test that the entity is in compliance with loan covenants and other significant provisions of the agreements.
b) If there are any provisions with which the entity is not in compliance, determine whether the debt should be classified as current.
c) If enforcement of the provisions has been waived by the lender in case of breach of any covenant by the entity, obtain confirmation of the waiver from the lender.

2) Examine the due dates on loans for **proper classification** between long-term and short- term.
3) Where instalments of long-term loans falling due within the next twelve months have been **disclosed in the financial statements** (e.g. in parentheses or by way of a footnote), **verify the correctness of the amount of such instalments**.
4) Examine the debt agreements for any **restrictive covenants**. Review restrictive covenant and provisions relating to default and ensure disclosure thereof in the financial statements.
5) Examine the **important terms in the loan agreements and the documents**, if any, **evidencing charge** in respect of such loans and advances.
6) Examine whether the **requirements of the applicable statute regarding creation and registration of charges have been complied** with including disclosure of the same to the extent mandated by statute and considered necessary for proper understanding of the user of financial statements.
7) In case the **value of the security falls below the amount of the loan outstanding**, examine whether the loan is classified as **secured only to the extent of the market value of the security**.
8) Examine the **hire purchase agreements** for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts, and **also examine the security aspect**.
9) He should carefully review the borrowings from related parties and ensure compliance with **AS 18 or IND AS 24**.
10) Verify whether liabilities towards bank in respect of bills discounted, bills negotiated, cheques discounted, etc. are **correctly reflected and disclosed in the financial statements**.
11) The auditor should also **verify that the amount borrowed** is within the borrowing powers of the company as laid down by the Articles of Association and Memorandum of Association.
12) Verify that the company has **not contravened the restrictions laid down by Section 180 of the Companies Act**, in respect of the borrowings of the company. **Also, check compliance of Sections 185 and 186 of the Companies Act, 2013**.
13) Examine the **purpose for which the amount is borrowed** and ensure that the amount is not used against the interest of the company.
14) Where the **entity has accepted deposits**, examine whether the directives issued by the Reserve Bank of India or other appropriate authority have been complied with.

Presentation & Disclosure

Ensure whether the following disclosures as required **under Schedule III (Part 1)** to Companies

Act, 2013 are made for each amount disclosed under the heading 'long term borrowings.

Long- Term Borrowings

1) Long-term borrowings shall be classified as:
   a) Bonds/debentures;
   b) Term loans:
      (i) from banks.
      (ii) from other parties.
   c) Deferred payment liabilities;
   d) Deposits;
   e) Loans and advances from related parties;
   f) Long term maturities of finance lease obligations;
   g) Other loans and advances (specify nature).
2) Borrowings shall further be sub-classified as
   a) secured and
   b) unsecured.

   Nature of security shall be specified separately in each case.
3) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
4) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.
5) Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed.
6) Terms of repayment of term loans and other loans shall be stated.
7) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

Other Long-term Liabilities

1) Other Long-term Liabilities shall be classified as:
   a) Trade Payables;
   b) Others

Short Term Borrowings:

1) Short-term borrowings shall be classified as:
   a) Loans repayable on demand;
      (i) from banks.

(ii) from other parties.

b) Loans and advances from related parties;

c) Deposits;

d) Other loans and advances (specify nature).

2) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

3) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

4) Period and amount of default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

5) Current maturities of long-term borrowings shall be disclosed separately.

IMPORTANT NOTES

Note 1: Where The Company Has Borrowings From Banks Or Financial Institutions On The Basis Of Security Of Current Assets, It Shall Disclose The Following:

a) Whether quarterly returns or statements of current assets filed by the Company with banks or financial institutions are in agreement with the books of accounts.

b) If not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed.

Note 2: Wilful Defaulter*

Where a company is a declared wilful defaulter by any bank or financial institution or other lender, following details shall be given:

a) Date of declaration as wilful defaulter,

b) Details of defaults (amount and nature of defaults),

* **wilful defaulter"** here means a person or an issuer who or which is categorized as a wilful defaulter by any bank or financial institution (as defined under the Act) or consortium thereof, in accordance with the guidelines on wilful defaulters issued by the Reserve Bank of India.

Note 3: Registration Of Charges Or Satisfaction With Registrar Of Companies

Where any charges or satisfaction yet to be registered with Registrar of Companies beyond the statutory period, details and reasons thereof shall be disclosed.

Note 4: Utilisation Of Borrowed Funds And Share Premium:

A. Where company has advanced or loaned or invested funds (either borrowed funds or share premium or any other sources or kind of funds) to any other person(s) or entity(ies), including foreign entities (Intermediaries) with the understanding (whether recorded in writing or otherwise) that the Intermediary shall

a) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company (Ultimate Beneficiaries) or

b) provide any guarantee, security or the like to or on behalf of the Ultimate Beneficiaries;
The company shall disclose the following:

(i) date and amount of fund advanced or loaned or invested in Intermediaries with complete details of each Intermediary.

(ii) date and amount of fund further advanced or loaned or invested by such Intermediaries to other intermediaries or Ultimate Beneficiaries alongwith complete details of the ultimate beneficiaries.

(iii) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(iv) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).;

B. Where a company has received any fund from any person(s) or entity(ies), including foreign entities (Funding Party) with the understanding (whether recorded in writing or otherwise) that the company shall:

a) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party (Ultimate Beneficiaries) or

b) provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries, the company shall disclose the following:

(i) date and amount of fund received from Funding parties with complete details of each Funding party.

(ii) date and amount of fund further advanced or loaned or invested other intermediaries or Ultimate Beneficiaries alongwith complete details of the other intermediaries' or ultimate beneficiaries.

(iii) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(iv) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).]

Note 5:

Where The Company Has Not Used The Borrowings From Banks And Financial Institutions For The Specific Purpose For Which It Was Taken At The Balance Sheet Date, The Company Shall Disclose The Details Of Where They Have Been Used.

TRADE PAYABLES AND OTHER CURRENT LIABILITIES

1) Liabilities in addition to borrowings, include trade payables and other current liabilities, deferred payment credits and provisions.
2) A liability is considered to be current if it is due to be paid within twelve months and held primarily for the purpose of being traded in the entity's normal operating cycle. E.g. Short term debt, dividends etc.
3) Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity.

The below table summarizes the audit procedures generally required to be undertaken while auditing trade payables and other current liabilities:

Assertions	Explanation
Existence	To establish the existence of trade payables and other current liabilities as at the period- end
Completeness & Cut-Off	Trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements.
Valuation	Trade payables and other liability balances have been valued appropriately.
Presentation and Disclosure	Required disclosures for trade payables and other liabilities have been appropriately made

Existence

1) Check whether there are **controls in place** to ensure that any purchase / expense **invoice does not get recorded more than once** and payable balances are automatically recorded in the general ledger at the time of recording of expense.
2) Obtain the **accounts payable ageing report** and trace its balances to the general ledger. If there are any differences, investigate reconciling items. If there are any differences, investigate reconciling items. Journal entries specially for large amounts should be carefully examined.

Direct confirmation procedures (Refer Procedure as per SA 505)

1) An important audit activity is to **contact vendors directly/independently** and ask them to confirm the amounts of accounts payable as of the end of the reporting period under audit.
2) This should necessarily be done for **all significant account payable balances** as at the period-end and for parties from whom material purchases have been made during the period under audit even if period-end balance of such parties is not significant.
3) The auditor employs **direct confirmation procedure** with the consent of the entity under audit.
4) There may be **situations where the management of the entity requests the auditor not to seek confirmation** from certain trade payables.
5) In such cases, the auditor should consider whether there are **valid grounds** for such a request.
6) In appropriate cases, the **auditor may also need to reconsider the nature, timing and extent of his audit procedures** including the degree of planned reliance on management's representations.
7) The trade creditors may be requested to confirm the balances either
   a) **as at the date of the balance sheet, or**
   b) **as at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company.**
8) The form of requesting confirmation from the trade creditor may be either
   a) **the form with balance** as at year end wherein the trade creditor is requested to respond whether or not he is in agreement with the balance shown, or
   b) **the form with no balance** wherein the trade creditor is requested to respond the balance as per his records. **The use of the form with no balance is preferable.**
9) The method of selection of the trade creditors to be circularized **should not be revealed to the Company** until the trial balance of the trade payables' ledger is handed over to the auditor.
10) A list of trade creditors selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.
11) The auditor should maintain strict control to ensure the correctness and proper dispatch of request letter.
12) In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may **fill in the names**, **addresses** and the **amounts relating to trade creditors** selected by him and mail the letters directly.
13) It should be ensured that **confirmations as well as any undelivered letters are returned to the auditor** and not to the client.
14) **Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample.**
15) **The entity should be asked to investigate and reconcile the discrepancies.**
16) In addition, the auditor should also consider **what further tests he can carry out in order to satisfy himself as to the correctness of the amount of trade payables taken as a whole.**
17) Where no reply is received, the auditor should perform additional testing regarding the

balances. This testing could include:

a) Testing of subsequent payments in respect of the trade payables to whom confirmations were rolled out but no replies received;

b) Agreeing the details of the respective balance to the underlying vendor invoices;

c) Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these purchases/ expense transactions actually occurred.

18) If there are any **related party payables**, review whether they were **properly authorized** and the value of such transactions were reasonable and at **arm's length**.

19) Review a **trend line** of purchases / expenses and accounts payable, or a comparison of the two over time, to see if there are any **unusual trends**. Make inquiries about reasons for changes in trends from the management.

Completeness & Cut-Off

1) The auditor needs to perform the following cut-off procedures:

a) For the **last 5 invoices received / recorded at the end of the reporting date** (cutoff date) and which have been included in the trade payables; the goods should have been received / risk and rewards of ownership in goods should have been transferred in favour of the entity;

b) **All goods received prior to the period / year- end should have been booked in the form of purchases and included in trade creditors.**

2) **Test purchases / expenses on a sample basis** selecting the same from the accounts payable ledgers and checking their supporting documents to ensure that the purchases were recorded at the correct amounts and correct dates.

3) Match purchase invoice dates to the gate entry (inward) dates to check whether the purchases are being recorded in the correct accounting period.

4) This can include an **examination of purchase / expense invoices received subsequent to the period being audited**, to see if they should have been included in the period under audit.

5) Review **subsequent expense vouchers**. Review all material expense vouchers recorded post the balance sheet date to see if they relate to transactions from within the audit period.

6) For advance received from **customers/ revenue received in advance**, obtain the customer wise listing along with its ageing and the nature.

7) **Enquire from the entity's management** if there has been any **dispute with the customer and if there is any additional liability to be recorded**.

8) For all such advances, the auditor should **verify the underlying documentation** based on which the entity had received the advance.

9) In relation to **statutory dues liability** like withholding tax (TDS) payable, GST payable, luxury tax payable, professional tax payable, PF and ESI payable etc., prepare a reasonability with respect to sales/ purchases/ employee benefit expenses.

For Example: GST liability for last month may be calculated by applying the applicable rate to the sales made and in case of any variance with the GST liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.

10) Similarly, **Provident Fund liability** for last month may be calculated by applying the applicable rate to the employee benefit expense and in case of any variance with the liability recorded by the entity, **reasons for variance should be requested from client** and in case found satisfactory, the same should be maintained as part of audit documentation.
11) Further, the auditor should **obtain and verify the challans for deposits** made subsequent to the period- end **for all statutory liabilities** as at the balance sheet date and also analyse the reasons, if any, in consultation with the management for any variance between the amounts deposited subsequently vis-à-vis the liability recorded in books of account.
12) He shall prepare a complete list of all statutory dues and consider his reporting requirements under CARO,2020.

Valuation

1) **Review the process followed by the Company to identify if any old creditor balance / liability needs to be written back.** This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
2) Obtain the **ageing of payable balances**, split between current, **less than 30 days old, 30-60 days old, 60-180 days old, 180- 365 days old and more than 365 days old.** Also, obtain the list of vendors with whom the Company has disputes and any claims from customers, under litigation and compare with previous year.
3) Check that **write backs in the liability balances** assessed as no longer payable have been **approved by an appropriate and authorised member of senior management**, for example CEO / MD.
4) Check that the **restatement of foreign currency trade payables has been done properly** in accordance with **AS 11**.
5) Understand management's process to identify the principal amount and the interest due thereon (if any) remaining unpaid to any Micro, Small and Medium Sized Enterprises suppliers at the end of accounting year.
6) Test check the management process to assess if the auditor could rely on the management process.

Presentation & Disclosure

Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made:

1) **Whether the Company has disclosed the following details relating to micro and small enterprises in the notes:**

a) The principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year.

b) The amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year.

c) The amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006.

d) The amount of interest accrued and remaining unpaid at the end of each accounting year.

e) The amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Trade Payables due for payment

The following ageing schedule shall be given for Trade Payables due for payment:

Trade Payable ageing Schedule

Particulars	Outstanding for following periods from due date of payment #				
	Less than 1 Year	1-2 Years	2-3 Years	More than 3 Years	Total
MSME					
Others					
Disputed Dues-MSME					
Disputed Dues Others					

 # Similar information shall be given where no due date of payment is specified in that case disclosure shall be from the date of the transaction. Unbilled dues shall be disclosed separately

Other Current Liabilities

Whether the amount disclosed under other current liabilities are classified as below:

a) Current maturities of finance lease obligations

b) Interest accrued but not due on borrowings

c) Interest accrued and due on borrowings

d) Income received in advance

e) Unpaid Dividends

f) Application money received for allotment of securities and due for refund and interest accrued thereon.

Note:

1) Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed.

2) It shall also be disclosed whether the company has sufficient authorised capital to cover the share capital amount resulting from allotment of shares out of such share application money.

3) Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed.

4) Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable, i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, **shall be separately shown under "Other current liabilities";**

   a) Unpaid matured deposits/debentures and interest accrued thereon

   b) Unpaid matured debentures and interest accrued thereon

   c) Others (specify nature).

PROVISIONS AND CONTINGENT LIABILITIES

1) **A provision** is a liability which can be measured only by using a substantial degree of Estimation. A provision is recognised when:

   a) an entity has a present obligation (legal or constructive) as a result of a past event;

   b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

   c) a reliable estimate can be made of the amount of the obligation.

   If the above conditions are not met, no provision is recognised.

2) **A contingent liability is:**

   a) a **possible obligation** that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

   b) a **present obligation** that arises from past events but is not recognized because:

      (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

      (ii) the amount of the obligation cannot be measured with sufficient reliability.

The below table summarizes the audit procedures generally required to be undertaken while auditing provisions and contingent liabilities:

Assertions	Explanation
Existence	To establish the existence of provisions as at the period- end
Completeness	Provisions that were supposed to be recorded have been recognized in the financial statements.
Valuation	Provision balances have been valued appropriately.
Presentation and Disclosure	Required disclosures for provisions have been appropriately made

Existence, Completeness & Valuation

1) **Obtain a list of all provisions** and compare them with balances in the ledger.
2) **Inspect the underlying arrangements** like agreement with customers to assess warranty commitments, any legal and other claims on the entity i.e. litigations.
3) Obtain the underlying working and the basis for each of the provisions made, from the management and **verify whether the same is complete and accurate.**
4) **Wherever required, obtain experts report**, calculation and underlying working for the provision amount,

   For Example, for warranty involving complex calculations, some entities get that valued through an actuary.
5) In such a case, the auditor may **request the management to share the actuarial valuation report** and in case of any matter under legal dispute, the auditor should request for assessment made by a legal expert in relation to likelihood of a liability devolving on the entity i.e. whether probable or possible or remote as defined above.
6) The auditor should then **verify the underlying assumptions used by the expert** with the data shared by the management.
7) **As per SA 500- Audit Evidence, issued by ICAI, when using the work of a management's Expert, audit evidence that the auditor should obtain include:**
   a) **Evaluate the competence, capabilities and objectivity of that expert:**
      (i) Whether the expert is employed by the entity or is an outside party.
      (ii) Whether the expert is independent in respect of the entity
      (iii) Auditor's previous experience of the work of the expert
      (iv) Knowledge of the expert's qualification, membership of a professional body or industry association
   b) **Obtain an understanding of the work of that expert:**
      (i) Whether the auditor has expertise to evaluate the work of the expert
      (ii) Evaluating the assumptions and methods used by the management.
      (iii) Evaluating the nature of internal or external data used by the expert

c) Evaluate the appropriateness of his work as audit evidence for the relevant assertion
   (i) Relevance and reasonableness of the Expert's findings or conclusions
   (ii) Evaluating the relevance, completeness and accuracy of the source data used by the Expert

8) The auditor shall **obtain written representation** from the management that it has made all the provisions which were required to be made as per the recognized accounting principles.

Presentation & Disclosure

1) **Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made:**

Long-term provisions

The amounts shall be classified as:

a) Provision for employee benefits

b) Others (specify nature)

Short-term provisions

The amounts shall be classified as:

a) Provision for employee benefits.

b) Others (specify nature).

Contingent liabilities and commitments (to the extent not provided for)

(i) Contingent liabilities shall be classified as:
   a) Claims against the company not acknowledged as debt;
   b) Guarantees;
   c) Other money for which the company is contingently liable.

(ii) Commitments shall be classified as:
   a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
   b) Uncalled liability on shares and other investments partly paid;
   c) Other commitments (specify nature).

2) **In terms of AS 29, "Provisions, Contingent Liabilities and Contingent Assets", ensure whether following disclosures have been made:**

   a) **For each class of provision, an enterprise shall disclose:**
      (i) The carrying amount at the beginning and end of the period
      (ii) Additional provisions made in the period, including increases to existing provisions;

(iii) Amounts used (i.e. incurred and charged against the provision) during the period;

(iv) Unused amounts reversed during the period.

b) **An enterprise shall disclose the following for each class of provision:**

(i) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(ii) An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; &

(iii) The amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.

c) **Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:**

(i) An estimate of its financial effect

(ii) An indication of the uncertainties relating to the amount or timing of any outflow; and

(iii) The possibility of any reimbursement.

Where any of the information required by above paragraph is not disclosed because it is not practicable to do so, that fact should be stated.

BALANCE SHEET CAPTIONS [ASSETS]

TRADE RECEIVABLES

1) Trade receivable are an essential part of any organization's balance sheet. often referred to as debtors.
2) Typically, an invoice is raised and issued to the customer with the invoice amount being recorded as a debtor balance. Until the invoice is paid, the invoice amount is recorded on the organization's balance sheet as accounts receivable.
3) If these balances are not recoverable later on, then these amounts need to be written off as bad and charged in the statement of profit and loss.
4) It is important to carry out Test of Controls for checking the effectiveness of internal control over sales as a part of the debtors' audit procedure.

Following points need to be considered in respect of trade receivables:

a) Only bona fide sales lead to trade receivables.
b) All such sales are made to approved customers.
c) All such sales are properly recorded in the books of accounts.
d) Once recorded, the debts can be settled only by receipt of cash or on the authority of a responsible official.
e) Segregation of duties at every point in sales transaction. (accounting for debtors, collecting the payments, sending reminders etc.)
f) Debts are collected on time.
g) In case debtors are not collected in time, sending reminders and taking legal actions if required.
h) Balances are regularly reviewed.
i) A proper system of follow up exists and if necessary, adequate provision for bad debt should be made by preparing adequate ageing schedule of the debtors.

After performing Test of Controls over sales, the auditor will decide upon the audit procedure to be applied to verify debtor's balance.

The below table summarizes the audit procedures generally required to be undertaken while auditing trade receivables:

Assertions	Explanation
Existence	To establish the existence of trade receivables as at the period end
Completeness & Cut-Off	Trade receivable balances that were supposed to be recorded have been recognized in the financial statements.
Valuation	Trade receivable balances have been valued appropriately.
Presentation and Disclosure	Required disclosures for trade receivables have been appropriately made

Existence

a) Check whether there are controls in place to ensure that **invoices cannot be recorded more than once** and **receivable balances are automatically recorded** in the general ledger from the original invoice.

b) Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger.

c) Check whether **realization is recorded invoice- wise or not**. If not, check that money received from debtors is adjusted **chronologically invoice- wise and on FIFO basis i.e. previous bill is adjusted first**.

d) If realization is made on account, verify whether the Company has **obtained confirmations from debtors** in respect of the same.

e) If any large balance is due for a long time, auditor should ask for reasons and justification for the same.

Direct confirmation procedures (Refer SA 505)

a) A significant and important audit activity is to **contact customers directly and ask them** to **confirm the amounts of unpaid accounts receivable** as of the end of the reporting period under audit.

b) This should **necessarily be done for all significant account balances** as at the period- end while certain random customers having smaller outstanding invoices should also be selected.

c) The auditor **employs direct confirmation procedure** with the consent of the entity under audit.

d) There may be situations where the **management of the entity requests the auditor not to seek confirmation** from certain trade receivables.

e) In such cases, the auditor should consider whether there are **valid grounds** for such a request.

f) In appropriate cases, the auditor may also need to **reconsider the nature, timing and extent of his audit procedures** including the degree of planned reliance on management's representations.

g) The trade receivables may be requested to confirm the balances either

(i) **As at the date of the balance sheet, or**

(ii) **As at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company.**

h) The form of requesting confirmation from the trade receivables may be either

(i) The **form with balance outstanding amount** as per the company, wherein the trade receivable is requested to respond **whether or not he is in agreement with the balance shown**, or

(ii) The **form without any balance** mentioned therein, wherein the **trade receivable is requested to respond with the balance outstanding** as per his records. **The use of the form without any balance is preferable.**

i) The method of selection of the trade receivables to be circularized **should not be revealed to** the Company until the trial balance of the trade receivables' ledger is handed over to the auditor.

j) A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.

k) The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters.

l) It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

m) Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample.

n) The Company should be asked to investigate and reconcile the discrepancies, if any.

o) Where no reply is received, the auditor should perform alternate procedures regarding the balances. This could include:

 (i) Agreeing the balance to cash received subsequently;

 (ii) Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred; (examination in depth for those balances)

p) If there are any related party receivables, review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

q) Check that receivables for other than sales or services are not included in the list.

r) Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends. i.e., perform analytical procedures. This will enable the auditor to check the reasonableness of balances.

s) Also, measure the average collection period.

t) Make inquiries about reasons for changes in trends with the management and document the same in audit work papers.

Completeness & Cut-Off

a) The auditor needs to satisfy himself of correct and proper cut-offs. Without a correct cut-off, sales could be understated or overstated, hence, the need to perform the following cut off tests:

 (i) For the invoices issued during the last few days (last 5 days of the reporting year) i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;

 (ii) Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis;

 (iii) Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.

b) **Test invoices listed in receivable report**. Select few invoices from the accounts receivable ageing report and **compare them to supporting documentation** to see if they were billed with the correct amounts, to the correct customers, and on the correct dates

c) **Match invoices to shipping / dispatch log**. Match invoice dates to the shipment dates for those items in the shipping / dispatch log, to see if sales are being recorded in the correct accounting period. This can include an **examination of invoices** issued subsequent to the period being audited, to see if they should have been included in the period under audit

d) **Assess bill and hold sales**. If there is a situation where the Company is billing customers for sales despite still retaining the **goods on-site** (known as "bill and hold"), examine supporting documentation to determine whether a sale has actually taken place or not.

e) **Review the receiving log** to see if the Company has recorded an inordinately large amount of customer returns after the audit period, which would suggest that the Company may have shipped more goods near the end of the audit period than what the customers had authorized to inflate the profits of the company;

f) Review the **process of giving discounts / incentives** and check whether the same were given as per the Company's policy / general industry trends.

g) **Review credit memos**, on a sample basis, issued during the audit period to see if they were **properly authorized** and whether they were **issued in the correct period**.

h) Also, review credit memos issued after the period end to see if they relate to transactions belonging to the period under audit.

i) **Where any deduction** has been made against a bill, check the reason and correspondence for the same.

Valuation

a) Review the process followed by the Company **to derive an allowance for doubtful accounts**.

b) This will include a **consistency comparison** with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.

c) Obtain the **ageing report of accounts receivable** (both Dr/Cr balance), split between not currently due, 30 days old, 30-60 days old, 60- 180 days old, 180- 365 days old and more than 365 days old.

d) Also, **obtain the list of debtors under litigation and compare with previous year**.

e) Scrutinize the analysis and **identify those debts which appear doubtful**.

f) Discuss with management about reasons, as to why these **debtors are not included in the provision for bad debts**.

g) Perform **further testing where any disputes exist**.

h) He should check if provisions are made at appropriate rates considering the recoverability of amounts due.

I) Prepare schedule of movements on **Bad Debts - Provision Accounts and Debts** written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years, to see if the current expense appears reasonable.

j) Check that **write-offs of the receivable balances** have been approved by an appropriate authority i.e. the Board of Directors in case of a company.

Presentation & Disclosure

1) Check that the **restatement of foreign currency trade receivables** has been done properly as per **AS 11**.
2) Proper disclosure of Related Party Transactions regarding receivables have been made as per **AS 18 or IND AS 24**.
3) Ensure that the transactions with parties covered under **Section 189** (Register of Contracts or Arrangements in which Directors are interested) of the Companies Act, 2013 are **reported properly in Companies Auditors' Report Order (CARO), 2020**.
4) Ensure whether the following **disclosures as required under Schedule III (Part 1)** to Companies Act, 2013 are made for each amount disclosed under the heading "Trade Receivables":
   a) Trade Receivable ageing schedule **(Refer table 1 below for the same)**
   b) Trade receivable shall be sub-classified as:
      (i) Secured, considered good
      (ii) Unsecured, considered good
      (iii) Doubtful.
   c) Allowances for bad and doubtful debts shall be disclosed under the relevant heads separately.
   d) Debts due by
      Verify that proper disclosure of amounts due from the following parties has been made:
      (i) **Directors or Other officers of the company or Any of them either severally or Jointly with any other person**
      (ii) **Firms or Private companies respectively in which any director is a partner or director or member should be separately stated.**

Trade Receivable ageing schedule (Table 1)

Particulars	Outstanding for following periods from due date of payments					
	Less than 6 Months	6 Months - 1 Year old	1-2 Years	2-3 Years	More than 3 Years	Total
(i) Undisputed TR - Considered Good.						
(ii) Undisputed TR - Considered Doubtful.						
(iii) Disputed TR - Considered Good.						
(iv) Disputed TR - Considered Doubtful						

Note: Similar information shall be given if no due date of payment is specified, in that case disclosure shall be from the date of the transaction. Unbilled dues shall be disclosed separately.

CASH AND CASH EQUIVALENTS

Cash and cash equivalent in the form of

a) **cash in hand,**

b) **stamps in hand,**

c) **balances held with bank in current accounts / margin money accounts,**

d) **cash credit accounts (debit balance),**

e) **fixed deposits,**

f) **cheques in hand etc.**

represent the most liquid assets of an enterprise. i.e. readily convertible into cash and subject to insignificant value risk. Utmost professional skepticism needs to be exercised while auditing such balances as they are prone to misappropriation.

The below table summarizes the audit procedures generally required to be undertaken while auditing cash and cash equivalents:

Assertions	Explanation
Existence	To establish the existence of cash and cash equivalent balances as at the period- end.
Completeness	Cash and cash equivalent balances that were supposed to be recorded have been recorded in the financial statements.
Valuation	Cash and cash equivalent balances have been valued appropriately.
Presentation and Disclosure	Required disclosures for cash and cash equivalents have been appropriately made

Existence & Completeness

1) Special care is necessary in regard to **verification of cash balances** for unless they are checked by surprise, there can be no certainty that the cash produced for inspection was in fact held by the custodian.

2) For this reason, the cash should be **checked not only on the last day of the year**, but also **checked again sometime after the close of the year without giving notice of the auditor's visit either to the entity or to his staff** (Surprise check).

3) If there are more than one cash balances, **e.g.**, when there is a cashier, a petty cashier, a branch cashier and, in addition, there **are imprest balances with employees**, all of them should be checked simultaneously, as far as practicable so that the shortage in one balance is not made

good by transfer of amount from the other.

4) It is desirable for the **cashier to be present while cash** is being counted and he should be made to sign the statement prepared containing details of the cash balance counted along with denomination of cash.

5) If he is absent at the time the cash is being verified, **he may hold the auditor responsible for the shortage, if any, in cash**.

6) If there is any **rough Cash Book** or details of daily balance are separately kept, the auditor should **test entries from the rough Cash Book** with those in the Cash Book to prove that entries in the Cash Book are correct.

7) If the auditor finds any slip, chit or I.O.U.s in respect of temporary advances paid to the employees included as part of the cash balance, he should **check whether those are approved by an authorized official or not and recorded in the appropriate accounts**.

8) The auditor should also **perform a cash sensitivity analysis** by compiling a summary of total cash receipts and payments each month and analyzing the trends to see if there have been variations in any specific month and request brief descriptions from the management.

9) The auditor needs to **obtain bank reconciliation statements** for all bank accounts maintained by the entity as at the reporting period and additionally need to understand the client's process and periodicity of making the BRS.

10) The auditor should ensure that BRS is signed by the **authorized personnel** so that he is able to assign responsibility in case of any errors.

11) Verification **of BRS shall entail the following:**

   a) Tallying the balance as per bank book to the bank confirmation/ statement

   b) Checking of all material reconciling items included under cheques issued but presented 'for payment' to the underlying bank book forming part of books of account.

   c) In addition, the auditor should request for bank statement of subsequent period and should verify if the cheques issued have subsequently been cleared by bank.

   d) For all cases where cheques have become stale i.e. 3 months or more have lapsed since the issue date, the same should not appear in the BRS and should instead be taken back to liabilities.

   e) Checking of all material reconciling items included under cheques deposited but not credited by bank by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period.

   f) For any instances related to cheques not cleared beyond reasonable time, the auditor should seek brief descriptions from the management and in case such explanations are found to be unsatisfactory, the auditor should verify the revenue recognition related to such parties was in order and as per the Company's revenue recognition policy.

   g) Checking of all material reconciling items included under amounts/ charges debited/ credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same.

h) If the amounts are found to be material, the auditor should ensure that the management records the adjustments for the same in its books of account.

I) If management does not adjust, the auditor shall consider to qualify his report.

Direct confirmation procedures:

1) A significant and important audit activity is to **contact banks / financial institutions directly and ask them to confirm the amounts** held in current accounts, deposit accounts, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit.
2) This should **necessarily be done for all account balances** as at the period-end.
3) The Company should be asked to **investigate and reconcile the discrepancies**, if any including seeking written explanations / clarifications from the banks / financial institutions on any unresolved queries.
4) The auditor should **emphasize for confirmation of 100% of bank account balances**.
5) In remote situations where no reply is received, the auditor should perform additional testing regarding the balances.
6) **This testing could include:**
   a) Agreeing the balance to bank statement received by the Company or internet/ online login to account in auditor's personal presence;
   b) Sending the audit team member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.

Valuation

In addition to the procedures performed above, **the auditor should ensure that all bank account holding foreign currency have been restated at the closing exchange rates as per AFRF**.

Presentation & Disclosure

Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been complied:

Cash and cash equivalents:

(i) Cash and cash equivalents shall be classified as:
   a) Balances with banks;
   b) Cheques, drafts on hand
   c) Cash on hand;
   d) Others (specify nature)

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months' maturity shall be disclosed separately.

INVENTORIES

1) Inventories are assets:
   a) held for sale in the ordinary course of business;
   b) in the process of production for such sale; or
   c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.
2) As per **AS 2- 'Valuation of Inventories', inventory is valued at lower of cost and net realisable value.**
3) The basis for valuation shall be **applied consistently year on year**. Any change in accounting policy shall have **adequate disclosures in financial statements**

The below table summarizes the audit procedures generally required to be undertaken while auditing ''inventories'':

Assertions	Explanation
Existence	To establish the existence of Inventories as at the period end.
Completeness & Cut-Off	Only the inventories held by entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party
Rights and Obligations	The entity has valid legal ownership rights over the inventories claimed to be held by the entity and recorded in the financial statements
Valuation	Inventories have been valued appropriately and as per generally accepted accounting policies and practices
Presentation and Disclosure	Required disclosures for inventories have been appropriately made

Existence

1) Review entity's plan for **performing inventory count**.
2) Ensure that consigned goods have been segregated.
3) Auditor should participate in the inventory count with the management.
4) Test counts of inventory by auditor should include:
   a) **Observing employees are adhering to the agreed plan.**
   b) **Assuring that there is appropriate supervision on the count procedure.**

c) Assuring that all items are properly tagged.

d) Observing that proper amounts are shown on tags.

e) Determining that tags and summary sheets are controlled and reconciled.

f) Reconciliation of test counts with tags and summary sheets and discrepancies noted, if any are summarized and agreed with client personnel.

g) Staying alert at all times and specifically being cautious about empty boxes, etc. and obsolete items.

h) Performing cut-off testing by documenting last 5-10 receiving reports and shipping documents as of the period end.

i) Ensuring exclusion of third party stock and damaged or obsolete stock.

j) Ensuring the accounting of all stock sheets.

k) Investigating any significant differences between the physical stock take and the stock records as per books.

l) Further, the auditor should ask the entity's personnel to sign all stock count sheets and also agree the variances observed, if any, to avoid any conflicts.

5) When the entity uses periodic system for inventory count, it should be undertaken at the **end of the period**.

6) If entity uses perpetual system with proper and adequate records, **inventory may be counted at interim dates**.

7) Confirm or investigate any inventory of the entity **lying with a third party** (specifically relevant for cases where the entity gets job work done in its process of production).

Completeness & Cut-Off

1) **Perform analytical procedures** (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).

   a) Compute inventory turnover ratio (COGS/ average inventory)

   b) Perform vertical analysis (inventory/ total assets)

   c) Compare budgetary expectations vis-à-vis actuals

2) Examine **non-financial information** related to inventory, such as weights and other measurement.

3) **Perform purchase and sales cut-off tests**. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.

4) With respect to **tagged inventory**, perform tests for omitted transactions and tests for invalid transactions.

5) Verify the **clerical and arithmetical accuracy** of inventory listings.

6) Reconcile **physical inventory amounts** with perpetual records.

7) Reconcile **physical counts with general ledger control totals**.

8) Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.
9) Goods received on consignment basis have been properly segregated from other items of inventory

Rights & Obligations

1) **Vouch recorded purchases** to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice, and cancelled cheque or payment file).
2) Evaluate **the consigned goods**.
3) Examine **client correspondence**, sales and receivables records, purchase documents.
4) **Determine existence of collateral agreements.**
5) **Review consignment agreements.**
6) **Review material purchase commitment agreements.**
7) **Examine invoices** for evidence of ownership i.e. the invoices shall be in the name of the client.
8) Auditor shall obtain confirmation for significant items of inventory as per SA 501.
9) **For instances** of **inventory held by third party**, the auditor should insist on **obtaining declaration from the third party on its business letterhead and signed by authorized personnel** of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

Valuation

Depending on how the business operates, the management may value inventory using **"first-in first-out," or a weighted average system**. Consider the **reasonableness** of the method adopted.

For Raw materials and consumables

1) **Ascertain what elements of cost are included e.g.** carriage inward, non-refundable duties etc.
2) If **standard costs are used**, **enquire into basis of standards**, how these are compared with actual costs and **how variances are analyzed and accounted for / treated in accounting records**.
3) **Test check cost prices** used with purchase invoices received in the month(s) prior to counting.
4) **Follow up valuation** of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a realistic net realizable value.

For Work in progress

1) Ascertain how the **various stages of production** / value additions are measured and in case estimates are made, understand the basis for such estimates.
2) **Ascertain what elements of cost are included.**
3) **If overheads are included**, ascertain the **basis on which they are included** and compare such basis with the available costing and financial data / information maintained by the entity.

4) Ensure that material costs **exclude** any abnormal wastage factors.

For Finished goods and goods for resale

1) **Enquire as to what costs are included**, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the financial statements.
2) **Ensure that inventories are valued at net realizable value** if they are likely to fetch a value lower than their cost.
3) For any such items, also **verify if the relevant semi / partly processed inventories** (work in progress) and raw materials have also been written down.
4) Follow up for items that are obsolete, damaged, slow moving and ascertain the **possible realizable value of such items**.
5) Carefully examine the valuation of obsolete and damaged inventory. For the purpose, request the client to provide **inventory ageing** split and between less than 30 days, 30-60 days old, 60-90 days old, 90- 180 days old, 180- 385 days old and more than 365 days old. follow up any inventories which at **time of observance of physical counting** were noted as being damaged or obsolete.
6) **Compare recorded costs with replacement costs.**
7) **Examine vendor price** lists to determine if recorded cost is less than current prices.
8) **Calculate inventory turnover ratio**. Obsolete inventory may be revealed if ratio is significantly lower.
9) In manufacturing environments, **test overhead allocation rates** and ensure that only direct labor, direct material and overhead have been included.
10) **Verify the correct application of lower-of-cost-or-net realizable value principles.**

Presentation & Disclosure

Ensure whether the following disclosures as required under **Schedule III (Part 1)** to the Companies Act, 2013 have been made:

1) Whether inventory has been classified as:
   a) Raw materials
   b) Work-in-progress
   c) Finished goods
   d) Stock-in-trade (goods acquired for trading)
   e) Stores and spares
   f) Loose tools
   g) Others (specify nature).
2) Whether goods-in-transit have been disclosed separately under each sub-head of inventories.
3) Mode of valuation shall be stated.

LAND, BUILDING, PLANT & EQUIPMENT, FURNITURE & FIXTURES, VEHICLES, OFFICE EQUIPMENT, COMPUTERS ETC. REFERRED TO AS "PROPERTY, PLANT AND EQUIPMENT" ("PPE")

1) The Valuation of PPE becomes a very important aspect of consideration by the auditor in the course of his audit. The auditor should analyze the expenditure incurred on PPE, whether they are of **Revenue or Capital in nature**.

2) Recognition Criteria for PPE The cost of an item of PPE should be recognised as an asset if, and only if:

   a) It is probable that future economic benefits associated with the item will flow to the enterprise, and

   b) The cost of the item can be measured reliably.

3) An enterprise evaluates under this recognition principle all its costs on property, plant and equipment at the time they are incurred.

4) These costs include costs incurred:

   a) initially to acquire or construct an item of property, plant and equipment; and

   b) subsequently to add to, replace part of, or service it.

5) **Measurement at Recognition:** An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost.

6) **Elements of Cost:**

   The cost of an item of property, plant and equipment comprises:

   a) its purchase price, including import duties and non -refundable purchase taxes, after deducting trade discounts and rebates.

   b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

   c) the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period

7) **Examples of directly attributable costs are:**

   a) costs of employee benefits (as defined in AS 15, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;

   b) costs of site preparation;

   c) initial delivery and handling costs;

   d) installation and assembly costs;

   e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

f) professional fees.

8) **Examples of costs that are not costs of an item of property, plant and equipment are:**

a) costs of opening a new facility or business, such as, inauguration costs;

b) costs of introducing a new product or service (including costs of advertising and promotional activities);

c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

d) administration and other general overhead costs.

The expenses have to be analysed and properly classified. The revenue expense like regular repairs on assets have to be charged off to the Statement of Profit and Loss.

The below table summarizes the audit procedures generally required to be undertaken while auditing tangible fixed assets:

Assertions	Explanation
Existence	To establish the existence of tangible fixed assets (PPE) as at the period- end
Completeness	Additions to PPE during the period under audit have been recorded in the financial statements and do not include any PPE that belong to third parties but does include PPE owned and controlled by the entity although lying with a third party
Valuation	PPE have been valued appropriately and as per generally accepted accounting policies and practices
Rights and Obligations	The entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements
Presentation and Disclosure	Required disclosures for PPE have been appropriately made

Existence

1) Review entity's plan for **performing physical verification of PPE** i.e. whether performed by own staff or by a third party and the policy regarding periodicity i.e. whether physical verification shall be done on annual basis or once in two years/ three years.

2) **Evidence of appropriate supervision of those performing physical verification of PPE should be examined.**

3) Obtain **PPE physical verification report** backed by the working sheets from the entity and perform the following procedures:

a) Assess if all items of PPE are properly tagged and carry identification marks / numbers and physical verification work papers do capture the asset identification numbers for assets physically verified.

b) Reconciliation of items of PPE as physically verified with the fixed asset register maintained by the entity as at the date/ period of undertaking physical verification. Specifically verify if the PPE additions up to the date of physical verification have been updated in the fixed asset register.

c) Verify the discrepancies noted, based on physical verification undertaken and the manner in which such discrepancies have been dealt with in the entity's books and financial statements,

For example: any identified shortages/ assets not in working condition and/ or active use should be accounted for as deletions in the books of account post approvals by the entity's management and depreciation charge should have ceased to be charged beyond the date of deletion.

Completeness

1) Verify the movement in the PPE schedule (asset class wise like building, P&M etc.) compiled by the management i.e. Opening + Additions - Deletions = Closing and tally the closing balance to the entity's books of account.

2) Check the arithmetical accuracy of the movement in PPE schedule, tally the opening balances to the previous year audited financial statements.

3) **For additions during the period under audit** Obtain a listing of all additions from the management and perform the following procedures:

a) For all material additions, verify if such expenditure meets the criteria of PPE as per AS 10 (Revised).

b) These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it.

c) Verify that the cost of an item of property, plant and equipment is as per AS 10 Revised.

d) Verify and ensure that items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with AS 10 (Revised) when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

e) Ensure that the entity is not recognizing costs of the day-to-day servicing in the carrying amount of an item of property, plant and equipment.

f) Test the purchase invoice, installation certificate or report or other similar documentation maintained by the entity to verify the date of addition, for all additions samples of PPE during the period under audit.

g) Verify whether the PPE additions have been approved by authorized personnel.

h) Verify whether proper internal processes and procedures like inviting competitive quotations/ floating tenders etc. **were followed** prior to finalizing the vendor for procuring items of PPE/ awarding of work contract for capital projects by checking the supporting documents of the samples selected.

4) **In relation to deletions to PPE**
   a) **understand from the management the reason and rationale for deletion** (example could be new purchase of similar asset once the old asset was no longer fit to be used in production process) **and the manner of disposal**.
   b) Obtain the **management approval and discard note** authoring disposal of the asset from its active use.
   c) Verify the process followed for sale of discarded PPE, **for example** inviting competitive quotes, tenders and the basis of calculation of sales proceeds.
   d) **Verify that the management has accurately recorded the deletion of PPE** (original cost and accumulated depreciation up to the date of disposal) and the resultant gain/ loss on disposal of PPE item in the entity's books of account.

Valuation

1) It is a common understanding that the value of fixed assets / PPE depreciates due to efflux of time, use and obsolescence. **The diminution of the value represents an item of cost to the entity for earning revenue during a given period.**
2) Unless this cost in the **form of depreciation is charged to the accounts**, the profit or loss would not be correctly ascertained and the values of PPE would be shown at higher amounts.
3) The auditor should:
   a) **Verify that the entity has charged depreciation on all items of PPE** unless any item of PPE is non- depreciating like freehold land;
   b) Assess that the **depreciation method used reflects the pattern** in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
   c) The auditor should also verify whether the management has done an **impairment assessment** to determine whether an item of property, plant and equipment is impaired as per the requirements of **AS 28 - Impairment of Assets.**

Rights & Obligations

1) In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all **PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity**.
2) For all additions to land and building in particular, the auditor should check the conveyance deed/ sale deed to verify whether the entity is the legal and valid owner or not.
3) **The auditor should insist and verify the original title deeds** for all immoveable properties held as at the balance sheet date.

4) In case the entity has given **such immoveable property as security for any borrowings** and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a **confirmation from the respective lenders** that they are holding the original title deeds of immoveable property as security.

5) In addition, the auditor should also **verify the register of charges**, available with the entity to assess that any charge has been created against the PPE.

Presentation & Disclosure

1) **Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made under the heading "Property, Plant and Equipment":**

   (i) Classification shall be given as:

      a) Land;
      b) Buildings;
      c) Plant and Equipment;
      d) Furniture and Fixtures;
      e) Vehicles;
      f) Office equipment;
      g) Others (specify nature).

   (ii) Assets under lease shall be separately specified under each class of asset.

   (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses / reversals shall be disclosed separately.

   (iv) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

IMPORTANT NOTES

Note 1: Title Deeds Of Immovable Property Not Held In Name Of The Company

The company shall provide the details of all the immovable property (other than properties where the Company is the lessee and the lease agreements are duly executed in favour of the lessee) whose title deeds are not held in the name of the company in format given below and where such immovable property is jointly held with others, details are required to be given to the extent of the company's share.

Relevant line item in the Balance sheet	Description of item of property	Gross carrying value	Title deeds held in the name of	Whether title deed holder is a promoter, director or relative # of promoter* / director or employee of promoter / director	Property held since which date	Reason for not being held in the name of the company**
PPE -	Land Building	-	-	-	-	** also indicate if in dispute
Investment property	Land Building					
PPE retired from active use and held for disposal	Land Building					
Others						

Relative here means relative as defined in the Companies Act, 2013.

*Promoter here means promoter as defined in the Companies Act, 2013.

Note 2: Where The Company Has Revalued Its Property, Plant And Equipment.

The company shall disclose as to whether the revaluation is based on the valuation by a registered valuer as defined under rule 2 of the Companies (Registered Valuers and Valuation) Rules, 2017.

Note 3: Capital-work-in Progress (CWIP)

a) For Capital-work-in progress, following ageing schedule shall be given: CWIP ageing schedule

CWIP	Amount in CWIP for a period of				Total
	Less than 1 Year	1-2 Years	2-3 Years	More than 3 Years	
Projects in Progress					
Projects temporarily suspended					

*Total shall tally with CWIP amount in the balance sheet.

b) For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given**:CWIPTo be completed in
Less than 1 Year1-2 Years2-3 YearsMore than 3 Years

CWIP	To be completed in			
	Less than 1 Year	1-2 Years	2-3 Years	More than 3 Years
Project 1				
Project 2				

**Details of projects where activity has been suspended shall be given separately.

INTANGIBLE ASSETS (COMPRISING GOODWILL, BRAND/ TRADEMARKS, COMPUTER SOFTWARE ETC.)

1) An Intangible Asset is an **identifiable non-monetary asset, without physical substance**, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

2) Enterprises frequently spend resources on the **acquisition, development, maintenance or enhancement of intangible assets such as scientific or technical knowledge, design and implementation of new processes or systems, licenses, intellectual property, market knowledge and trademarks** (including brand names and publishing titles).

3) Common examples of items encompassed by these broad headings are **computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights**.

4) **Goodwill** is another example of an item of intangible nature which either arises on acquisition or may be internally generated.
5) Not all the items described in above paragraph will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise.
6) If an item covered by this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.
7) As per AS 26 - Intangible Assets, internally generated goodwill should not be recognized as an asset.
8) Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures).
9) The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.
10) In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant.
11) For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

The below table summarizes the audit procedures generally required to be undertaken while auditing intangible fixed assets:

Assertions	Explanation
Existence	To establish the existence of intangible fixed assets as at the period- end
Completeness	All Additions to Intangible assets during the period under audit have been recorded appropriately in the financial statements
Valuation	Intangible assets have been valued appropriately and as per generally accepted accounting policies and practices
Rights and Obligations	The entity has valid legal ownership rights over the Intangible assets claimed to be held by the entity and recorded in the financial statements
Presentation and Disclosure	Required disclosures for Intangible assets have been appropriately made

Existence

1) Since an Intangible Asset is an identifiable non-monetary asset, without physical substance, for establishing the existence of such assets, the auditor should **verify whether such intangible asset is in active use** in the production or supply of goods or services, for rental to others, or for administrative purposes.

   Example- for verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services / goods during the period under audit, in which such software has been used.

   Example- For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity.

2) In case any intangible asset is not in active use, **deletion should have been recorded in the books of account** post approvals by the entity's management and amortization charge should have ceased to be charged beyond the date of deletion.

Completeness

1) Verify the movement in the Intangible assets schedule (asset class wise like software, designs / drawings, goodwill etc.) compiled by the management **i.e. Opening + Additions - Deletions = Closing and tally the closing balance to the entity's books of account.**

2) Check the **arithmetical accuracy** of the movement in intangible asset schedule, tally the opening balances to the previous year audited financial statements.

3) **For additions during the period under audit - Obtain a listing of all additions from the management and undertake the following procedures:**

   a) For all material additions, verify whether such **expenditure meets the criterion for recognition of an intangible asset as per AS 26.**

   b) Ensure that no intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

   c) **Check the certificate or report or other similar documentation** maintained by the entity to **verify the date of use** of the intangible which could be linked to **date of commencement** of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit.

   d) **Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.**

   e) Verify whether **proper internal processes and procedures** like inviting competitive quotations/ proper tenders etc. **were followed** prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis.

4) **In relation to deletions to intangible assets,**

   a) **understand from the management the reason and rationale for deletion and the manner of disposal.**

b) Obtain the **management approval and discard note** authoring discard of the asset from its active use. Verify the process followed for sale of discarded asset, example inviting competitive quotes, tenders and the basis of calculation of sales proceeds.

c) Verify that the management has **accurately recorded the deletion of intangible asset** (original cost and accumulated amortization up to the date of disposal) and the resultant gain/ loss on discard in the entity's books of account.

Valuation

1) The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period.

2) Unless this cost in the form of amortization is charged to the accounts, the profit or loss would not be correctly ascertained and the values of intangible asset would be shown at higher amounts.

3) The auditor should:

   a) **Verify that the entity has charged amortization on all intangible assets;**

   b) **Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.**

   c) **The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired.**

   d) For the purpose, the auditor needs to verify whether if the entity has applied **AS 28, Impairment of Assets** for determining

      (i) The manner of reviewing the carrying amount of its intangible asset,

      (ii) Determining the recoverable amount of the asset to determine impairment loss, if any.

Rights & Obligations

In addition to the procedures for verifying completeness of additions to intangible assets during the period under audit, the auditor while performing testing of additions should also **verify that all expense invoices / purchase contracts are in the name of the entity that entitles legal title of ownership to the respective entity.**

Presentation & Disclosure

1) **Ensure that the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made under the heading "Intangible Assets":**

   (i) Classification shall be given as:

      a) *Goodwill*

      b) *Brands/trademarks*

      c) *Computer software*

      d) *Mastheads and publishing titles*

      e) *Mining rights*

f) Copyrights, and patents and other intellectual property rights, services and operating rights

g) Recipes, formulae, models, designs and prototypes

h) Licenses and franchise

i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets) and other adjustments and the related depreciation and impairment losses or reversals shall be disclosed separately.

(iii) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

NOTE 1: INTANGIBLE ASSETS UNDER DEVELOPMENT

a) **For Intangible assets under development, following ageing schedule shall be given:**

Intangible Assets under development ageing schedule

Intangible assets under development	Amount in CWIP for a period of				Total
	Less than 1 Year	1-2 Years	2-3 Years	More than 3 Years	
Projects in Progress					
Projects temporarily suspended					

*Total shall tally with the amount of Intangible Assets under development in the balance sheet.

b) **For Intangible assets under development, whose completion is overdue or has exceeded its cost compared to its original plan, following Intangible assets under development completion schedule shall be given**:**

Intangible assets under development	To be completed in			
	Less than 1 Year	1-2 Years	2-3 Years	More than 3 Years
Project 1				
Project 2				

**Details of projects where activity has been suspended shall be given separately.

LOANS AND ADVANCES AND OTHER CURRENT ASSETS

1) Loans and advances include loans and advances to
   a) related parties,
   b) security deposits,
   c) capital advances,
   d) amounts recoverable in cash or in kind or for value to be received, e.g., rates, taxes and insurance paid in advance / prepaid.
2) Other current assets primarily include **balances with statutory / government authorities** etc.

The below table summarizes the audit procedures generally required to be undertaken while auditing loans and advances and other current assets:

Assertions	Explanation
Existence	To establish the existence of loans and advances and other current assets as at the period- end
Completeness	Loans and advances and other current asset balances that were supposed to be recorded have been recognized in the financial statements.
Valuation	Loans and advances and other current asset balances have been valued appropriately.
Presentation and Disclosure	Required disclosures for loans and advances and other current assets have been appropriately made

Existence

For establishing existence of loans and advances, **direct confirmation procedures**, similar to those performed for **''Accounts receivable''** balances are should be performed with the only difference that while undertaking circularization of direct confirmations, in addition to the principal amount, **interest received / receivable**, if any, as per the agreed terms between the parties, **may also be included as part of the balance to be confirmed**.

Completeness

1) Obtain a **list of all advances and other current assets** and compare them with balances in the ledger.
2) **Verify loan agreements** and acknowledgements of parties in respect of outstanding loans. A loan or an advance, if material, is granted only if authorised by the Memorandum and Articles of Association in the case of Company.
3) In addition, the auditor should confirm that the loans advanced were within the competence of

persons who had advanced the same, directors in the case of a Company, partners in the case of a firm and trustees in the case of a trust.

4) **Inspect the minutes of meeting of board of directors** to confirm if all material loans and advances were approved by the board of directors.

5) **Verify that the loan has been acknowledged by the party** and in addition, inspect if any security has been deposited against due repayment of the loan.

6) Ascertain if loans are being **recovered regularly** as per agreed instalments.

7) If there are any **related party loans and advances**, review whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

8) In relation to **balances with statutory authorities** like GST input credit, prepare a reasonability with respect to purchases/ expenses by applying the applicable rate to the purchases/ expenses and in case of any variance with the asset recorded by the entity, **reasons for variance should be requested from the entity**.

9) Further, the auditor should **obtain statutory returns** filed with the authorities like GST returns and verify whether the amount recorded as per books of account tallies with the claim made with the authorities.

Valuation

1) **Assess the allowance for doubtful accounts**. Review the process followed by the Company to derive an allowance for doubtful accounts.

2) This will include a **consistency comparison** with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.

3) Obtain the **ageing report of loans and advances**, split between not currently due, 30 days old, 30 - 60 days old, 60 - 180 days old, 180 - 365 days old and more than 365 days old.

4) Also, **obtain the list of loans and advances under litigation** and compare with previous year.

5) **Scrutinize the analysis and identify those loans and advances that appear doubtful; Discuss with management** about the reasons as to why these loans/ advances are **not included in the provision for doubtful balances**.

6) Assess bad loans / advances write-offs. Prepare **schedule of movements** on Bad loans/ advances - Provision Accounts and loans/ advances written off.

7) Check that write-offs or other reductions in the **recoverable balances** have been approved by the authorsied and appropriate senior authority.

8) Check that the **restatement of foreign currency loans and advances** / other current assets has been done properly in **accordance with AS 11**.

Presentation & Disclosure

Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made:

Long Term loans & Advances

a) **Long-term loans and advances shall be classified as:**

(i) Loans to related parties (giving details thereof)

(ii) Capital advances

(iii) Other loans and advances (specify nature).

b) The above shall also be separately sub- classified as:

(i) Secured, considered good

(ii) Unsecured, considered good

(iii) Doubtful.

c) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

d) Loans and advances due by

(i) Directors or other officers of the company or any of them either severally or jointly with any other persons or

(ii) Amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Short Term loans & Advances

a) Short-term loans and advances shall be classified as:

(i) Loans and advances to related parties (giving details thereof)

(ii) Others (specify nature).

b) The above shall also be separately sub- classified as:

(i) Secured, considered good

(ii) Unsecured, considered good

(iii) Doubtful.

c) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

d) Loans and advances due by

(i) Directors or other officers of the company or any of them either severally or jointly with any other persons or

(ii) amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

IMPORTANT NOTE

Following disclosures shall be made where Loans or Advances in the nature of loans are granted to promoters, Directors, KMPs and the related parties (as defined under Companies Act, 2013) either severally or jointly with any other person, that are:

a) repayable on demand or

b) without specifying any terms or period of repayment

Type of Borrower	Amount of loan or advance in the nature of loan outstanding	Percentage to the total Loans and Advances in the nature of loans
Promoters		
Directors		
KMPs		
Related Parties		

STATEMENT OF PROFIT AND LOSS CAPTIONS

SALE OF PRODUCTS AND SERVICES

1) The sales and collections cycle in a business refers to the set of processes that begin when a customer purchases goods or services and ends when the entity receives complete payment against the sales.
2) As part of the year-end audit of an entity's financial statements, auditors test sales transactions and the internal controls over those transactions to ensure that the entity is not materially misstating its revenues or accounts receivable.
3) Auditor needs to obtain a clear understanding about the organization and its revenue centers. To understand the same, **he should consider the following:**
   a) An auditor needs to **obtain an understanding of the management control** (internal control) in respect of sales process.
   b) An auditor **tests the controls the entity** has set up for the sales cycle to **determine how strong and reliable they are**. If they are strong and operating effectively, the auditor can reduce the extent of substantive testing. Any deficiencies in the internal control shall be communicated as per SA 265.
   c) The auditor selects a **random sample of transactions and examines** the related customer purchase orders, invoices and customer statements to ensure that the control being tested is a numbered sales invoice. This will enable the auditor to determine the nature, timing and extent of his substantive procedures to be applied.
   d) **Performing substantive audit procedures is must**. Substantive analytical procedure will consist of **sales trend analysis, comparison with previous accounting period, category wise sales analysis,** any analysis the auditor may find relevant and most important of all building a sales expectation and compare that with the client's sales records.
   e) The auditor will need to **know the sales prices** of the products or services over the **year, monthly average sales price per product** or service, discount policy.

The below table summarises the audit procedures generally required to be undertaken while auditing sales:

Assertions	Explanation
Occurrence	Recorded sales represent goods shipped / services performed during the period
Completeness & Cut-Off	All sales made during the period were recorded and there in no understatement or overstatement.
Measurement	All sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted
Presentation and Disclosure	Required disclosures for sales have been appropriately made

Occurrence

1) Ensure revenue is not overstated by performing following audit procedures:
   a) **Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded.**
   b) **Test check few invoices with their relevant entries in sales journal.**
   c) **Obtain confirmation from few customers to ensure genuineness of sales transaction.**
   d) **Whether any fictitious customer and sale has been recorded.**
   e) **Whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure.**
   f) **Whether unearned revenue recorded as earned.**
   g) **Whether any substantial uncertainty exists about collectability.**
   h) **Whether customer obligations are contingent on other actions (financing, resale, etc.).**
2) Review sequence of sales invoices
3) Review journal entries for unusual transactions
4) Calculate the **ratio of sales return to sales** and compare it with previous year and enquire for the reasons for increase/ decrease.
5) Check the **sales return with sales invoice**, challan, credit note, stock register, etc.

Completeness & Cut-Off

a) **Perform cut-off test** to ensure that revenues are recognised in the current accounting period and sales were not tampered towards the period end.

b) **Cut- off errors will usually arise when companies recognise revenue based on the date on which the sales invoices are generated** rather than the date on which the risks and rewards are transferred to the buyer.

c) In order to perform a robust sales cut-off test, auditors need to **understand and consider** the specific cut- off error risk of each engagement.

d) Auditors should also verify the "**Credit notes**" issued after the accounting period.

e) Sometimes sales team or sales personnel can make **fictitious sales** before the year-end to meet performance target and cancel out those sales with a post year end credit note.

f) **Trace from the shipping documents to the sales journal**

g) Check whether **quantity is appearing in sales register** or not and **check reconciliation of total sales/goods** dispatched as per stock records and financial records and statutory records like GST.

h) Review GST tax and GST returns and ensure that the same are reconciled with revenue reported in the profit and loss account. Verify reasonability say of GST by applying the applicable rate to the gross sales value and compare the amount of GST as per statutory returns and analyze the reasons for variance, if any.

Measurement

a) **Trace a few transactions from inception to completion. Example:** Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The recognition shall be according to the revenue recognition policy of the entity.

b) **If the client is engaged in export sales, then compliance with AS 11 shall be ensured**

c) Auditor must **understand client's operations and related GAAP issues e.g.** point of sale revenue recognition vs. percentage of completion, wherever applicable.

d) Compare the **rate of sales affected with related parties** and review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

Presentation & Disclosure

1) Ensure whether the following disclosures as required under **Schedule III (Part II) to Companies Act, 2013** have been made:

   (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from—

   (a) Sale of products;

   (b) Sale of services;

   (ba) Grants or donations received (relevant in case of section 8 companies only),]

   (c) Other operating revenues;

   Less:

   (d) Excise duty.

   (B) In respect of a finance company, revenue from operations shall include revenue from—

   (a) Interest; and

   (b) Other financial services.

2) Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

   a) Whether brokerage and discount on sales other than usual trade discount has been disclosed.

   b) Whether the transactions with related parties are appropriately disclosed in notes to accounts.

OTHER INCOME COMPRISING INTEREST INCOME, DIVIDEND INCOME, GAIN / LOSS ON SALE OF INVESTMENTS ETC.

Any form of income earned by an entity which is **not linked to the entity's core business operations** is generally classified as other income.

Examples – interest on excess funds parked in fixed deposits with banks (the entity not being a bank or financial institution), interest on loans given to third parties/ within the group, return on mutual fund investment etc.

1) **Interest income on fixed deposits** is recognized on a **time proportion basis** taking into account the amount outstanding and the applicable interest rate.
2) **Dividends are recognised** in the statement of profit and loss only when:
   a) the entity's **right to receive payment** of the dividend is established;
   b) it is probable that the **economic benefits associated with the dividend will flow** to the entity; and
   c) the amount of the dividend can be **measured reliably**.
3) **Gain/(loss) on sale of investment in mutual funds** is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

Assertions	Explanation
Occurrence	Recorded other income was earned during the period
Completeness	Other income earned during the period was appropriately recorded and there in no understatement or overstatement.
Measurement	Other income has been measured appropriately as per the applicable accounting standards.
Presentation and Disclosure	Required disclosures for other income have been appropriately made

Interest Income

For verifying interest income on fixed deposits:

a) Obtain a **listing of fixed deposits** opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period.
b) **Verify the arithmetical accuracy** of the interest calculation made by the entity by recomputing i.e. multiplying the deposit amount with the applicable rate and number of days during the period under audit.

c) For deposits still outstanding as at the period- end, **trace the same to the direct confirmation** obtained from the respective bank/ financial institution.

d) Obtain a **confirmation of interest income** from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.

e) Also, obtain a copy of **Form 26AS** (TDS withholding by the bank / financial institution) and reconcile the interest reflected therein to the calculation shared by client.

Dividend Income

For Dividends, verify that the same are recognised in the statement of profit and loss only when the entity's **right to receive payment of the dividend is established.**

Gain / (loss) on sale of Investment in Mutual Funds

Verify that **Gain / (loss) on sale of investment in mutual funds is recorded as other income** only on

a) transfer of title from the entity and

b) is determined as the difference between the redemption price and carrying value of the investments.

For the purpose, **obtain the mutual fund statement** and trace the gain / loss as recorded in the books of account to the gain / loss as reflected in the statement.

Presentation and Disclosure

Ensure whether the following disclosures as required under **Schedule III (Part II)** to Companies Act, 2013 have been made:

Other income

Other income shall be classified as:

(a) Interest Income (in case of a company other than a finance company);

(b) Dividend Income;

(c) Net gain/loss on sale of investments;

(d) Other non-operating income (net of expenses directly attributable to such income).

NOTE: TO BE DISCLOSED AS ADDITIONAL INFORMATION

Undisclosed income

The Company shall give details of **any transaction not recorded in the books of accounts** that has been **surrendered or disclosed as income** during the year in the tax assessments under the Income Tax Act, 1961 (such as, search or survey or any other relevant provisions of the Income Tax Act, 1961), unless there is immunity for disclosure under any scheme and also shall state whether the previously unrecorded income and related assets have been properly recorded in the books of account during the year.

PURCHASES

1) Purchases are another significant process of an entity. Similar to sales as discussed above, purchases and disbursement cycle in a business refers to the **set of processes that begin** when an order for buying goods or services is placed based on requirements of the production / user department and ends when the entity received the product and makes complete payment to the vendor.
2) As part of the year-end au dit of an entity's financial statements, **auditors test purchase transactions** and the internal controls over those transactions to ensure that **the entity is not materially misstating its purchases or accounts payables**.
3) Auditor needs to obtain a clear understanding about the organisation and its production centres.

   For Example: Type of services or products they procure that are used in the production / rendering of services, sources of procurement whether domestic or overseas, general availability and terms and conditions of purchase of the service or products, major vendors, credit period, quality checks, purchase terms (Credit or cash purchase) etc.

Auditor should consider the following:

1) An auditor needs to **identify the control points** over purchases **e.g.**
   a) whether segregation of duties exist,
   b) whether competitive quotes are invited,
   c) whether a purchase committee exists who authorises purchase price,
   d) who issues and authorizes purchase orders,
   e) when and how the goods are received and acknowledged,
   f) who checks the quality, quantity and specifications of the goods received and prepares Goods Receipt Note (GRN),
   g) who approves the vendor invoice,
   h) whether a 2 way / 3 way match process exists (i.e. tally between purchase order, GRN and vendor invoice),
   i) how the purchases have been recognized in the system.
2) An auditor tests the controls the entity has set up for the purchase cycle to **determine whether they are effective or not**.
3) **If the controls are effective, the auditor can reduce the extent of substantive testing.**
4) Common internal controls over the purchase cycle include
   a) inviting of competitive quotations for shortlisting the vendor,
   b) numbered purchase orders,
   c) purchase order authorization over a certain limit,
   d) generation of GRN on receipt of goods,

e) quality inspection of goods,
f) 2 way / 3-way match,
g) authorization of purchase invoices.
h) appropriate authority to recognise the purchases in the system.

5) The auditor **selects a random sample of transactions and examines** the related purchase orders, GRN, purchase invoices, inward gate entry register and vendor reconciliation/ statements.

6) **Performing substantive audit procedures is must.** Substantive analytical procedure will consist of **purchase trend analysis, comparison with previous accounting period, category wise purchases,** any analysis auditor may find relevant and most important of all setting a purchase expectation in relation to the sales made during the period under audit and compare that with the client's purchase records.

7) The auditor would need to **know the purchase prices** of the products or services over the year, monthly average purchase price per product or service etc.

   For Example: If the purchase price is 100 and if 15000 units were received under multiple orders during the year, the auditor expects the purchases to be 15,00,000. If there is a variance in the amount recorded in the books, he shall check for additional details like discounts received, change of purchase price for few orders due to excess demand etc.

The below table summarizes the audit procedures generally required to be undertaken while auditing purchases:

Assertions	Explanation
Occurrence	Recorded purchases represent goods actually received / services availed during the period
Completeness & Cut-Off	All purchases made during the period were recorded and there in no understatement or overstatement.
Measurement	All purchases have been measured appropriately
Presentation and Disclosure	Required disclosures for purchases have been appropriately made

Occurrence

Ensure purchases are not understated / overstated by performing following audit procedures:

a) Whether any **fictitious vendors have been booked or purchases** have been recorded by reviewing the vendor selection process followed by the entity and also performing procedures to ensure existence of the vendors.

b) Whether the **goods were received at the factory gate** and **whether there exists an entry in the security gate inward register**

c) Whether **quality inspection of goods** was done

d) Whether a **goods receipt note** was prepared and signed by an appropriate client personnel

e) Whether the **purchase invoice was approved** as per delegation of authority and whether a 3 or 2-way match (as discussed above) was done

f) Whether **stock record** has been updated by the stores personnel.

Special considerations during audit of purchases

a) The purchase invoice received should be the "**Original**" copy (and not photocopy / carbon copy) against which the entity has recorded the purchase in its books of account.

b) Purchase invoice should have been **booked only once risk** and reward incidental to ownership has been transferred to the entity. Specific consideration for cases where the terms of delivery as agreed with vendor are F.O.B., C.I.F. etc.

c) Purchase invoice should be **in the name of entity**. However, in case of different branches, it should be addressed to the appropriate branch.

d) **Input tax component** should have been booked in the input tax ledger, the auditor should obtain a copy of the input tax returns filed with the authorities and tally the input tax as reflected in the books to the amount disclosed in the returns.

e) In case of purchases made from related parties or allied and associated concerns, the auditor needs to verify **if requisite approval from Board of Directors** (appropriate authority) has been obtained and should verify the selected samples and perform analytical procedures in relation to price of goods to confirm that the **price charged is at arm's length**.

f) The auditor should review **whether purchases should be capitalized or expensed** off in Statement of Profit and loss according to his professional judgment.

g) Review journal entries for **unusual transactions**.

Completeness & Cut-Off

In addition to the procedures for establishing occurrence of purchases as discussed above, the auditor should:

a) Perform **cut-off test** to ensure that purchases are recognised in the **correct accounting period**.

b) For the purpose, the auditor should **examine material inward** records say **last 5 transactions** at the period end to check that all corresponding invoices have been duly entered in the Purchases book and none have been omitted.

c) **Ensure correct accounting treatment of goods - in - transit** as per the agreed terms with the vendor regarding transfer of risk and reward of ownership in goods.

d) Obtain **written representation from the management** that all the purchases that took place during the year have **been properly recorded in the books**.

Measurement

Perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include:

a) **Consumption Analysis:** Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from Management If any significant variations found.

b) **Stock Composition Analysis:** Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations.

c) **Ratios:** Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.

d) Auditor should review **quantitative reconciliation** of closing stocks with opening stock, purchases and consumption.

Presentation & Disclosure

Ensure whether the following disclosures as required under **Schedule III (Part II)** to Companies Act, 2013 have been made:

a) Whether **purchases of stock-in-trade** has been specifically disclosed

b) Whether **changes in inventories** of finished goods, stock-in-trade and work- in-progress have been specifically disclosed.

c) Whether the **transactions with related parties** are appropriately disclosed in notes to accounts.

EMPLOYEE BENEFITS EXPENSE

1) Employee benefits expenses or commonly called as **payroll expenses** represents the **aggregate sum an entity pays as a consideration to its employees for their labour / efforts**, along with associated expenses such as perquisites/ benefits, postemployment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training.

2) In many industries, employee benefit expense is the **biggest expense category** and hence, it is **critical for businesses to manage this expenditure shrewdly** and for the auditors, to **verify and ensure that such expenditure is appropriate and has been accounted as per applicable accounting standards and generally accepted accounting principles.**

Auditor needs to obtain a clear understanding about the organisation and its hiring, appraisal and retirement process in the following manner:

a) An auditor tests the controls the entity has set around employee benefit payment process to **determine how effective they are**. If they are effective, the auditor can reduce the substantive testing.

b) Common internal controls over the employee benefit payment cycle **includes**

(i) **maintaining of attendance records,**

(ii) employee master,

(iii) authorisation and approval of monthly payroll processing and

(iv) disbursement,

(v) computation of employee deductions like payroll taxes,

(vi) accrual of other benefits like gratuity, leave encashment, bonus etc.

c) The auditor selects a **random sample of transactions and examines** the related appointment letters, appraisal letters, attendance records, HR policies, employee master etc.

d) **Performing substantive audit procedures is must.** Substantive analytical procedure will consist of **monthly expense reasonability, comparison with previous accounting period,** any analysis auditor may find relevant and most important of all setting an expectation in relation to the expense incurred during the period under audit and compare that with the client's business operations and overall trend in the industry.

The below table summarises the audit procedures generally required to be undertaken while auditing employee benefits expense:

Assertions	Explanation
Occurrence	Recorded emplyee benefit expenses were actually incurred during the period
Completeness	Employee benefit expenses pertaining to the period have been recorded appropriately.
Measurement	Employee benefit expenses have been measured appropriately. There in no understatement or overstatement.
Presentation and Disclosure	Required disclosures for employee benefit expenses have been appropriately made

Occurrence & Completeness

a) Obtain an **understanding of entity's process** of capturing employee attendance.

b) There is always a risk that an entity could record expense for **fictitious employees.**

c) To address this risk, the auditor may choose to **meet the employees in person**, on a sample basis.

d) Further, the auditor may choose to **select a sample of employees** and ask the payroll department to share their bank details / identity proofs of the employees.

e) Obtain a list of employees as at the period- end along with a monthly movement **split between new hires, leavers and continuing employees.**

f) For a sample (selected randomly) of **new hires, obtain the appointment letter** and verify whether the salary for first month and subsequent months was processed as per the agreed terms.

g) For a sample (selected randomly) of **resigned employees**, **obtain their full and final computation** and verify whether all their dues including **post-retirement benefits like gratuity, leave encashment have been paid** and whether the **respective employee's acknowledgement on final computation** has been obtained.

Measurement

a) Obtain the **monthly salary registers** for all 12 months. Compile a monthly payroll reasonability by calculating the average salary per employee per month and compare with the previous year and preceding month and analyses the reasons for variance which could be attributable to annual increments, an employee at senior level joining/ leaving the entity, bonus pay-out etc.

b) Verify if **accrual/ provision** has been made for all **employee benefits and obligations like bonus, gratuity, leave encashment etc**.

c) In case **Provident Fund (PF), Employee State Insurance (ESI)** are applicable to the entity, compile a reasonability by applying the rate to the basic wages and comparing to the amount recorded in books and analyses reasons for variance, if any.

d) Also, **obtain monthly deposit challans** to verify if the month on month liability was subsequently deposited with the authorities and within the defined timelines.

e) **Perform analytical procedures** to obtain audit evidence as to overall reasonableness of employee benefit expense which may include production per employee analysis.

f) Auditor should **analyse units produced per employee** and compare the same with previous years and present industry trends and ask for the reasons from Management, if any significant variations are found.

Presentation & Disclosure

Ensure whether the following disclosures as required under **Schedule III (Part II)** to Companies Act, 2013 have been made:

(a) Employee Benefits Expense [showing separately

(i) Salaries and wages,

(ii) Contribution to provident and other funds,

(iii) Expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP),

(iv) Staff welfare expenses].

DEPRECIATION AND AMORTISATION

1) One of the key principles of accrual basis of accounting requires that an **asset's cost is proportionally expensed based** on the period over which the asset is expected to be used.
2) Both depreciation and amortization are methods that are used to **prorate the cost of a specific type of asset over its useful life**.
3) Depreciation represents **systematic allocation of the depreciable value of an item of PPE over its useful life** while amortisation represents systematic allocation of the depreciable amount of an intangible asset over its useful life.
4) Depreciation and amortisation generally constitute an entity's significant part of overall expenses and have direct impact on the profit/ loss of the entity, hence, auditors need to **verify and ensure that such expenditure is appropriate, accurately calculated and has been accounted as per applicable provisions** of Companies Act or other statutes, to the extent applicable on the respective industry and as per generally accepted accounting principles.

Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

a) Obtain the **understanding of entity's accounting policy** related to depreciation and amortisation.
b) Ensure the Company policy for charging depreciation and amortisation is **as per the relevant provisions of Companies Act/applicable accounting standards**.
c) The accounting policy has been applied consistently year on year. Any change in the accounting policy has been adequately disclosed.
d) Whether the depreciation has been calculated **after making adjustment** of residual value from the cost of the assets.
e) Whether depreciation and amortisation **charges are valid**.
f) Whether depreciation and amortisation charges are **accurately calculated and recorded**.
g) Whether all depreciation and amortisation charges are recorded in the **appropriate period**.
h) Whether each part of an item of PPE with a cost that is significant in relation to the total cost of the item have been depreciated separately.

   For Example: It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.
I) Whether the most appropriate depreciation method for each separately depreciable component has been used.

The below table summarises the audit procedures generally required to be undertaken while auditing depreciation and amortization expense:

Assertions	Explanation
Completeness	Depreciation and Amortisation expenses pertaining to the period have been recorded appropriately and there in no understatement/ overstatement.
Measurement	Depreciation and amortisation expenses have been measured appropriately
Occurrence	Recorded depreciation and amortisation expenses were actually incurred during the period
Presentation and disclosure	Required disclosures for depreciation and amortisation have beer appropriately made.

Completeness & Occurrence

a) Obtain an **understanding of entity's process** of charging depreciation and amortization.

b) Obtain the **fixed asset register** maintained by the entity.

c) **There is always a risk that an entity could capitalize expense of revenue nature to increase its profit or charge capital expenditure directly in income and expense statement to reduce its profit.**

d) To address this risk, the auditor may choose to **check the nature of asset from fixed asset register** and further, there is always a risk that fake asset has been capitalized in the books and to mitigate this risk, auditors should **physically verify** the fixed assets, **at least the ones that are material in value**.

Measurement

a) Obtain a list of all **additions / deletions** along with their proper approval from the authorised person for the same.

b) Select the **sample of assets** from the Fixed Assets Register, on materiality considerations and verify the rates of depreciation, depreciation calculation.

c) Obtain the list of **all the components identified** by the management.

d) Ensure **Intangible assets like patents, goodwill, copy rights have been properly amortized over the period.**

e) Ensure depreciation is charged on the assets from the date when it is ready to use. and not from the date of actual usage. In other words, depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management.

f) Ensure **depreciation on revalued amount has been properly accounted from revaluation reserve.**

g) Depreciation **computation as per Income tax Act, 1961**- Ensure that **additions are tallying with the additions as per Companies Act** and the opening WDV to the Tax audit schedule for the assessment year preceding the previous year under audit.

h) **Perform analytical procedures** to obtain audit evidence as to overall reasonableness of depreciation and amortisation expense- check the arithmetical accuracy of records and perform independent calculations example- compute or re-compute the depreciation expense for the year

i) Ensure that the **depreciation and amortization** has been charged as per the useful lives of PPE and intangible assets.

j) Ensure that **residual values** have been properly verified as that impacts the computation of depreciation.

k) **Ensure that the depreciation and amortization has been computed prospectively whenever there is any change in useful lives of PPE and intangible assets.**

Presentation & Disclosure

Ensure whether the following disclosures as required under have been made:

a) **Accounting policy for depreciation and amortization**

b) **Useful lives of assets as per schedule II to the Companies Act, 2013.**

c) **Residual value of assets**

d) **Depreciation method**

OTHER EXPENSES LIKE POWER AND FUEL, RENT, REPAIR TO BUILDING, PLANT AND MACHINERY, INSURANCE, TRAVELLING, LEGAL AND PROFESSIONAL, MISCELLANEOUS EXPENSES.

An entity in addition to making purchases and incurring employee benefit expenses also incurs on other expenditure like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations.

While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:

a) Whether the expenditure pertained to **current period** under audit;

b) Whether the expenditure qualified as a **revenue and not capital expenditure**;

c) Whether the expenditure had a **valid supporting documents like travel tickets**, insurance policy, third party invoice etc.;

d) Whether the expenditure has been **classified under the correct expense head**;

e) Whether the expenditure was **authorised as per the delegation of authority matrix;**

f) Whether the expenditure was in **relation to the entity's business** and not a personal expenditure.

The below table summarises the audit procedures generally required to be undertaken while auditing other expenses:

Assertions	Explanation
Occurrence	Recorded other expenses were actually incurred during the period.
Completeness	Other expenses pertaining to the period have been recorded appropriately and there in no understatement or overstatement
Measurement	Other expenses have been measured appropriately
Presentation and Disclosure	Required disclosures for other expenses have been appropriately made

Audit Procedures for specific expenses Rent expense

a) Obtain a **month wise expense schedule** along with the rent agreements.

b) Verify if **expense has been recorded for all 12 months** and whether the rent amount is as per the underlying agreement.

c) Specific consideration should be given to **escalation clause** in the agreement to verify if the rent was required to be recorded on a straight-line basis during the period under audit.

d) Also, verify if the **agreement is in the name of the entity** and whether the expense pertains to premises used for running business operations of the entity.

Power and fuel expense

a) Obtain a **month wise expense** schedule along with the power bills.

b) Verify if expense has been recorded for all 12 months.

c) Also, **compile a month wise summary of power units consumed** and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis.

d) In relation to the units consumed, **analyse the monthly power units** consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.

Insurance expense

a) Obtain a summary of insurance policies taken along with their validity period.

b) Verify if the expense has been correctly classified between prepaid and expense for the period based on number of days.

Legal and professional expenses

a) **Obtain a month wise and consultant wise summary**.

b) In case of **monthly retainer ship agreements**, verify if the expenditure for all 12 months has been recorded correctly.

c) For **non- recurring expenses**, **select a sample** and **vouch for the attributes discussed above**.

d) **The auditor should be cautious while vouching for legal expenses** as the same may highlight a dispute for which the entity may not have made any provision and the matter may also not have been discussed/ highlighted to the auditor for his specific consideration.

Travel, repair and maintenance, printing and stationery, miscellaneous expenses

a) **The auditor should select a sample and vouch for the attributes discussed above.** Wherever possible, the auditor and try to prepare a summary of expenditure on monthly basis and then analytically compare the trends.

b) **Perform analytical procedures** to obtain audit evidence as to overall reasonableness of other expense which may include **expenditure per unit produced analysis.**

c) Auditor should analyse expense per unit produced and compare the same with previous years and present industry trends and ask for the reasons from Management If any significant variations are found.

Presentation and Disclosure

Ensure other expense have been classified under:

a) Rent.

b) Insurance.

c) Power and fuel.

d) Repairs and maintenance- Building, Plant and machinery, others.

e) Legal and professional.

f) Printing and stationary.

g) Travel expenses.

h) Miscellaneous expenses.

IMPORTANT NOTES

Note 1: Corporate Social Responsibility (CSR)

Where the company covered under section 135 of the companies act, the following shall be disclosed with regard to CSR activities:

a) amount required to be spent by the company during the year,

b) amount of expenditure incurred,

c) shortfall at the end of the year,

d) total of previous years shortfall,

e) reason for shortfall,

f) nature of CSR activities,

g) details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard,

h) where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately.

Note 2: Details of Crypto Currency or Virtual Currency

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:

a) profit or loss on transactions involving Crypto currency or Virtual Currency

b) amount of currency held as at the reporting date,

c) deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency.

Note 3 : Details of Benami Property Held

Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following:-

a) Details of such property, including year of acquisition,

b) Amount thereof,

c) Details of Beneficiaries,

d) If property is in the books, then reference to the item in the Balance Sheet,

e) If property is not in the books, then the fact shall be stated with reasons,

f) Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor then the details shall be provided,

g) Nature of proceedings, status of same and company's view on same.

Note 4 : Relationship with Struck off Companies

Where the company has any transactions with companies struck off under section 248 of the Companies Act, 2013 or section 560 of Companies Act, 1956, the Company shall disclose the following details:-

Name of struck off Company	Nature of transactions with struck off Company	Balance outstanding	Relationship with the Struck off company, if any, to be disclosed
	Investments in securities		
	Receivables		
	Payables		
	Shares held by stuck off company		
	Other outstanding balances (to be specified)		

Note 5: Following Ratios to be disclosed:

a) Current Ratio,
b) Debt-Equity Ratio,
c) Debt Service Coverage Ratio,
d) Return on Equity Ratio,
e) Inventory turnover ratio,
f) Trade Receivables turnover ratio,
g) Trade payables turnover ratio,
h) Net capital turnover ratio,
i) Net profit ratio,
j) Return on Capital employed,
k) Return on investment.

The company shall explain the items included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

Audit Documentation

Please refer SA 230 in Module 1 (SA Module)

Completion and Review

Please refer SA 260, 265, 450, 560, 570 & 580
in Module 1 (SA Module)

AUDIT REPORT

CARO - 2020

In exercise of the powers conferred by **sub-section (11) of section 143** of the Companies Act, 2013, the **Central Government**, after consultation with the **National Financial Reporting Authority** constituted under **section 132** of the Companies Act, 2013, hereby makes the following Order, namely:

Applicability of the Order

The CARO, 2020 is an additional reporting requirement. The order applies to every company including a foreign company as defined in the Companies Act, 2013.

However, the Order specifically exempts the following classes of companies:

1) a **banking company** as defined in the Banking Regulation Act, 1949 ;
2) an **insurance company** as defined under the Insurance Act,1938 ;
3) a **company** licensed to operate under **section 8** of the Companies Act;
4) a **One Person Company** as defined in **clause (62) of section 2** of the Companies Act and a **small company** as defined in **clause (85) of section 2** of the Companies Act; and
5) a **private limited company,**
    a) not being a **subsidiary or holding company of a public company,**
    b) having a **paid up capital and reserves and surplus** not more than **one crore rupees** as on the balance sheet date and
    c) which does not have **total borrowings exceeding one crore rupees** from any bank or financial institution **at any point of time** during the financial year and
    d) which does not have a **total revenue as disclosed in Scheduled III** to the Companies Act **(including revenue from discontinuing operations) exceeding ten crore rupees** during the financial year as per the financial statements.

Auditor's report to contain matters specified in paragraphs 3 and 4

Every report made by the auditor under section 143 of the Companies Act on the accounts of every company audited by him, to which this Order applies, for the financial years commencing on or after the 1st April, 2019, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable:

Provided this Order **shall not apply to the auditor's report on consolidated financial** statements **except clause (xxi)** of paragraph 3.

MATTERS TO BE INCLUDED IN AUDITOR'S REPORT

The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:

(i) Property, Plant and Equipment

a) (A) whether the company is **maintaining proper records** showing full particulars, including **quantitative details** and **situation of Property, Plant and Equipment**;

(B) whether the company is **maintaining proper records** showing full particulars of **intangible assets**;

b) whether these **Property, Plant and Equipment** have been **physically verified by the management** at reasonable intervals; whether any **material discrepancies were noticed** on such verification and if so, whether the same have been **properly dealt** with in the books of account;

c) whether the **title deeds** of all the **immovable properties** (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are **held in the name of the company**, if not, provide the details thereof in the format below:

Description of property	Gross carrying value	Held in name of	Whether promoter, director or their relative or employee	Period held - indicate range, where appropriate	Reason for not being held in name of company*
-	-	-	-	-	*also indicate if in dispute

d) whether the company has **revalued its Property, Plant and Equipment** (including Right of Use assets) or **intangible assets** or both during the year and, if so, whether the revaluation is based on the **valuation by a Registered Valuer**; specify the amount of change, **if change is 10% or more** in the aggregate of the **net carrying value of each class of Property, Plant and Equipment or intangible assets;**

e) whether **any proceedings** have been initiated or **are pending against** the company for holding any **benami property** under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements;

(ii) Inventory

a) whether **physical verification of inventory** has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the **coverage and procedure** of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;

b) whether during **any point of time of the year**, the company has been sanctioned **working capital limits in excess of five crore rupees**, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the **quarterly returns or statements** filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

(iii) Whether during the year the company has **made investments** in, provided any **guarantee or security** or granted **any loans or advances** in the nature of loans, **secured or unsecured, to companies, firms, Limited Liability Partnerships** or any other parties, if so,-

a) Whether during the year the company has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other entity **[not applicable to companies whose principal business is to give loans]**, if so, indicate-

(A) the **aggregate amount during the year**, and **balance outstanding** at the balance sheet date with respect to such loans or advances and guarantees or security to **subsidiaries, joint ventures and associates**;

(B) the **aggregate amount during the year**, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to **parties other than subsidiaries, joint ventures and associates**;

b) whether the **investments made, guarantees provided, security given** and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are **not prejudicial** to the company's interest;

c) in respect of **loans and advances** in the nature of loans, whether the **schedule of repayment of principal and payment of interest** has been stipulated and whether the **repayments** or **receipts are regular**;

d) if the **amount is overdue**, state the **total amount overdue** for **more than ninety days**, and whether **reasonable steps** have been taken by the company **for recovery of the principal and interest**;

e) whether any loan or advance in the nature of loan granted which has fallen due during the year, has been **renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties**, if so, specify the **aggregate amount of such dues renewed or extended or settled by fresh loans** and the percentage of the aggregate to the total loans or advances in the nature of loans granted during the year **[not applicable to companies whose principal business is to give loans]**;

f) whether the company has granted any loans or advances in the nature of loans either **repayable on demand or without specifying any terms** or **period of repayment**, if so, specify the aggregate amount, percentage thereof to the total loans granted, **aggregate amount of loans granted** to **Promoters, related parties** as defined in clause (76) of section 2 of the Companies Act, 2013;

(iv) in respect of **loans, investments, guarantees, and security**, whether provisions of **sections 185 and 186** of the Companies Act have been complied with, if not, provide the details thereof;

(v) in respect of **deposits accepted by the company** or amounts which are **deemed to be deposits**, whether the directives issued by the Reserve Bank of India and the provisions of **sections 73 to 76** or any other relevant provisions of the Companies Act and the rules made thereunder, where applicable, have been complied with, if not, the nature of such contraventions be stated; **if an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India** or any court or any other tribunal, whether the same has been complied with or not;

(vi) whether **maintenance of cost records** has been specified by the Central Government under **sub-section (1) of section 148** of the Companies Act and whether such accounts and records have been so made and maintained;

(vii) Statutory Dues

a) whether the company is **regular** in **depositing undisputed statutory dues** including

(i) Goods and Services Tax,
(ii) provident fund,
(iii) employees' state insurance,
(iv) income-tax,
(v) sales-tax,
(vi) service tax,
(vii) duty of customs,
(viii) duty of excise,
(ix) value added tax,
(x) cess and any other statutory dues

to the appropriate authorities and if not, the **extent of the arrears of outstanding** statutory dues as on the **last day of the financial year** concerned **for a period of more than six months** from the **date they became payable**, shall be indicated;

b) where statutory dues referred to in sub-clause (a) **have not been deposited on account of any dispute**, then **the amounts involved and the forum** where dispute is pending shall be mentioned **(a mere representation to the concerned Department shall not be treated as a dispute);**

(viii) whether any transactions not recorded in the books of account have been **surrendered or disclosed as income** during the year in the tax assessments under the Income Tax Act, 1961

(43 of 1961), if so, whether the previously **unrecorded income has been properly recorded** in the books of account during the year;

(ix) Default in Repayment

a) Whether the company has **defaulted in repayment of loans** or other **borrowings** or in the **payment of interest** thereon to any lender, if yes, the **period** and the **amount of default** to be reported as per the format below:

Nature of borrowing, including debt securities	Name of lender*	Amount not paid on due date	Whether principal or interest	No. of days delay or unpaid	No. of days delay or unpaid Remarks, if any
	*lender wise details to be provided in case of defaults to banks, financial institutions and Government.				

b) whether the company is a **declared wilful defaulter** by any bank or financial institution or other lender;

c) whether **term loans were applied for the purpose** for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;

d) whether **funds raised on short term basis have been utilised for long term purposes**, if yes, the nature and amount to be indicated;

e) whether the company has taken **any funds from any entity** or person on account of or to meet the **obligations of its subsidiaries, associates or joint ventures**, if so, details thereof with nature of such transactions and the amount in each case;

f) whether the company has **raised loans during the year** on the **pledge of securities held in its subsidiaries, joint ventures or associate companies**, if so, give details thereof and also report if the company has defaulted in repayment of such loans raised;

(x) Usage of Funds

a) whether **moneys raised by way of initial public offer or further public offer** (including debt instruments) during the year were **applied for the purposes for which those are raised**, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;

b) whether the company has made any **preferential allotment or private placement of shares or convertible debentures** (fully, partially or optionally convertible) during the year and if so, whether the requirements of **section 42 and section 62** of the Companies

Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance;

(xi) Frauds

a) whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;

b) whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;

c) whether the auditor has considered whistle-blower complaints, if any, received during the year by the company;

(xii) Nidhi Company

a) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability;

b) whether the Nidhi Company is maintaining ten percent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;

c) whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof;

(xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards;

(xiv) Internal Audit

a) whether the company has an internal audit system commensurate with the size and nature of its business;

b) whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor;

(xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with;

(xvi) NBFC

a) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 (2 of 1934) and if so, whether the registration has been obtained;

b) whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934;

c) whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria;

d) whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group;

(xvii) whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses;

(xviii) whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors;

(xix) on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date;

(xx)

a) whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VII to the Companies Act within a period of six months of the expiry of the financial year in compliance with second proviso to sub-section (5) of section 135 of the said Act;

b) whether any amount remaining unspent under sub-section (5) of section 135 of the Companies Act, pursuant to any ongoing project, has been transferred to special account in compliance with the provision of sub- section (6) of section 135 of the said Act;

(xxi) whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements, if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

Reasons to be stated for unfavourable or qualified answers

1) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.

2) Where the auditor is unable to express any option on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion in the same.

SECTION 143 - DUTIES OF AUDITORS

Reporting requirement relating to matters stated in Section [Sec.143(1)]	a) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members. b) Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company. c) Where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company. d) Whether loans and advances made by the company have been shown as deposit. e) Whether personal expenses have been charged to revenue account. f) Where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading. Note: The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) is reproduced below: (i) The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. (ii) If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. (iii) Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse.
Reporting on accounts examined Sec. 143(2)	Under provisions of Section 143(2), the auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under subsection (11). Further, auditor has to report whether to best of his information and

	knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as prescribed under Rule 11 of the Companies (Audit and Auditors) Rules, 2014.
Duty to Report on principal assertions [Sec. 143 (3)]	a) Whether he has **sought and obtained all the information** and **explanations** which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, details thereof and the effect of such information on the financial statements. b) Whether, in his opinion, **proper books of account** as **required by law** have been kept by the company so far as appears from his examination of those books and proper returns, adequate for the purposes of his audit have been received from branches not visited by him. c) Whether the **report** on the accounts of any **branch office of** the company audited by a person other than the company's auditor has been sent to him and the manner in which he has dealt with it in preparing his report. d) Whether the company's balance sheet and profit and loss account dealt with in the **report** are in **agreement** with the books of account and returns. e) Whether, in his opinion, the financial statements comply with the **accounting standards**. f) The observations or comments of the auditors on financial transactions or matters which have any **adverse effect** on the functioning of the company. g) Whether any director is **disqualified** from being appointed as a director under **sub - section (2) of section 164**. h) Any qualification, reservation or adverse **remark** relating to the maintenance of accounts and other matters connected therewith. i) Whether the company has **adequate Internal Financial Control with reference to Financial Statements** in place and **the operating effectiveness** of such controls. <u>Applicability of Reporting on IFC's under Section 143(3)(i)</u> **Section 143(3)(i) shall not apply to a private limited company which is:** (i) A one-person company or (ii) A small company or (iii) Company having **turnover less than rupees fifty crore** as per latest audited financial statements <u>AND</u> Which has **aggregate borrowings** from banks or financial institutions or anybody corporate at any point of time during the financial year **less than**

	rupees twenty-five crore. j) Such other matters as are prescribed in Rule 11 of the Companies (Audit and Auditors) Rules, 2014
Rule 11 Sec.143(3)(j)	The auditor shall include in his report, his views and comments on the following matters: a) Whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement. b) Whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts. c) Whether there has been any delay in transferring amount, required to be transferred, to the Investor Education and Protection Fund by the company. d) i) Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; ii) Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and iii) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the

	representations under sub-clause (i) and (ii) **contain any material mis-statement.** e) Whether the **dividend declared or paid** during the year by the company **is in compliance with section 123** of the Companies Act, 2013. f) [Whether the company, in respect of financial years commencing on or after the 1st April, 2022,] **has used such accounting software for maintaining its books of account** which has a **feature of recording audit trail (edit log) facility** and the same has been operated throughout the year for all transactions recorded in the software and the **audit trail feature has not been tampered** with and the audit trail has been preserved by the company as per the statutory requirements for record retention.]	
Duty to state the Reasons for qualification or negative report [Sec. 143(4)]	Where any of the matters required to be included in the audit report is answered in the **negative or with a qualification**, the report shall state the reasons thereof.	
Power to appoint Government Company Auditor [Sec. 143 (5)]	a) In the case of a Government company, CAG shall **direct the auditor** the **manner** in which the accounts of the Government company are required to be audited. b) The auditor shall **submit a copy** of his audit report to CAG. c) The audit report shall, among other things, include the directions, if any, issued by CAG, the **action taken** thereon and its **impact** on the accounts and financial statement of the company.	
Power to conduct Supplementary Audit & comment thereupon [Sec. 143 (6)]	CAG shall, **within 60 days** from the date of receipt of the audit report, have the following rights:	
	Supplementary Audit	To conduct a supplementary audit under section 143(6)(a), of the financial statement of the company a) by **such person or persons** as he may authorize in this behalf; and b) for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, c) **by such person or persons, and in such form,** as the Comptroller and Auditor-General of India may direct;
	Supplement / comment	a) **Comment upon or Supplement** such audit report under section 143(6)(b). b) It may be noted that any comments given by the

<table>
<tr><td></td><td></td><td>Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. and
c) Also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.</td></tr>
<tr><td>Test Audit [Sec. 143 (7)]</td><td colspan="2">a) Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.
b) As stated above, in the case of a government company, audit is conducted by professional auditors appointed on the advice of the C&AG and the later is authorised under section 143 of the Companies Act, 2013 to conduct supplementary or test audit.
c) The C&AG shall direct the manner in which the company's accounts shall be audited by the statutory auditors and give such auditors instructions in regard to any matter relating to the performance of his functions as such. The directions under section 143(6) broadly covers the system of book-keeping and accounts, internal control etc.
d) The C&AG has power to conduct a supplementary or test audit of the company's accounts by such person as he may authorise in this behalf and for the purposes of such audit require information or additional information to be furnished to any person or persons so authorised on such matters by such person or persons and in such form as the C&AG may by general or special order, direct.
e) The statutory auditors shall submit a copy of their audit report to the C&AG who shall have a right to comment upon or supplement the audit report submitted by the statutory auditors in such manner as he may think fit. Section 134(3) of the Companies Act, 2013 imposes a duty on the board of directors of a company to give an explanation or comments on every reservation, or adverse remarks or disclaimer contained in the auditors' report and secretarial audit report of the Company Secretary in practice. In the absence of similar provisions requiring the company to give reply on the reservation made by the C&AG, the board of directors of such a company is not bound to give information or explanation in respect of such comments.</td></tr>
</table>

	The general standards, principles, techniques and procedures for audit adopted by the C&AG are a **mixture of government audit and commercial audit as known and practiced by professional auditors**. The concepts of autonomy and accountability of the institution / bodies / corporations / companies have influenced the nature and scope of audit in applying the conventional audit from the **angle of economy, efficiency and effectiveness.**
Duty to comply with Auditing Standards [Sec. 143(9)]	a) Every auditor shall comply with the auditing standards. b) Further, as per **sub-section 10 of section 143 of the Companies Act 2013**, the Central Government may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.
Reporting on any other matter specified by Central Government: [Sec. 143(11)]	As per section 143(11), the Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein
Reporting on frauds: [Sec. 143(12)-(15)]	a) **Reporting to the Central Government-** As per **section 143(12)** of the Companies Act, 2013 read with **Rule 13** of the Companies (Audit and Auditors) Rules, 2014, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of **Rs. 1 crore or above**, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as prescribed. b) **Reporting to the Audit Committee or Board-** In case of a **fraud** involving lesser than the specified amount **[i.e. less than ₹ 1 crore]**, the auditor shall report the **matter to the audit committee** constituted under section 177 or **to the Board** in other cases within such time and in such manner as prescribed. c) Besides, auditor has also to report matters pertaining to fraud at point **(xi) of paragraph 3 of CARO, 2020**

REFER SA 299, 600, 700, 701, 705, 706 & 710 FROM SA MODULE 1.

AUDIT OF DIFFERENT TYPES OF ENTITIES

STEPS INVOLVED IN SPECIAL AUDIT

Major points that must be kept in mind while performing the audit of Educational Institution, Charitable Institutions, Cinema Hall, Hospital etc.

1) Constitution of Organisation (Refer Note 1 for details)
2) Evaluating the Internal Control System in the Organisation
3) Examine the accounting policies followed & the accounting records maintained
4) Check the various receipts of the organisation in the form of fees, rent, donations, grants, etc.
5) Check the various expenses of the organisation such as staff. common expenses etc.
6) Verification of Assets & Liabilities
7) Audit Report

Note 1: Constitution of the organisation

a) Examine the constitution of the organization.
b) Examine the **bye laws or rules and regulations** or **trust deed.**
c) Examine the **powers of the members** of the management and other officers.
d) Examine the **minute books of managing committee** and of the members general meeting as the case may be.

AUDIT OF LOCAL BODIES

Background

1) A municipality can be defined as a unit of local self-government in an urban area.
2) **'Local self-government'** ordinarily means the administration of a locality - a village, a town, a city or any other area smaller than a state.
3) It raises its **revenue through local taxation** and **spends its income on services which are regarded as local and therefore, distinct from state and central servives.**
4) Municipal government in India covers five distinct types of urban local authorities:

a) **The municipal corporations,**
b) **The municipal councils,**
c) **The notified area committees**
d) **The town area committees**
e) **The cantonment committees**

5) Municipal authorities are endowed with specific local functions covering:
   a) **Regulatory,**
   b) **Maintenance and**
   c) **Development activities.**
6) Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:
   a) **General administration and revenue collection,**
   b) **Public health,**
   c) **Public safety,**
   d) **Education,**
   e) **Public works, and**
   f) **Others such as interest payments, etc.**
7) Property taxes and octroi are the major sources of revenue of the municipal authorities; other municipal taxes are profession tax, non-mechanised vehicles tax, taxes on advertisements, taxes on animals and boats, tolls, show-tax, etc.
8) The taxation powers of the corporations are confined to a few items and are of a generally compulsive nature; on the other hand, the tax powers of other types of urban local authorities cover a wider range, optional in nature and subject to a procedure for their imposition requiring the final sanction of the state governments.

Types of Revenue Grants

Local bodies may receive different types of grants from the state administration as well. Broadly, the revenue grants are of three categories:

a) **General purpose grants:** These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.
b) **Specific purpose grants:** These grants which are tied to the provision of certain services or performance of certain tasks.
c) **Statutory and compensatory grants:** These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

FINANCIAL ADMINISTRATION

Budgetary Procedure	1) The objectives of local bodies budgetary procedure are: a) Financial Accountability, b) Control of expenditure, and 2) The **main objective is to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations** and within the limits of sanction and authorisation by legislation or council. 3) Budget preparation is usually the occasion for determining the levels of taxation and rates and the ceilings on expenditure. 4) Municipal budget formats and heads of accounts vary from state to state. There are variations between the corporation and municipalities. 5) One important feature of the municipal budgets is that there is **no strict separation between revenue and capital items;** usually there is a **'head'** called extraordinary items which cover most of the capital transactions. 6) There are, however, a number of **special funds** (e.g. roads) or in some cases separate budgets for specific municipal functions (e.g. education) or enterprise activities (e.g., water supply and sanitation, transport, electricity, etc.)
Expenditure Control	1) The system of financial control existing in the state and central government level is conditioned by the fact that there is a **clear demarcation between the legislature and executive**. 2) The **integration** of legislation and executive powers in the municipal council makes it **difficult** for its executive to function as its inquisitorial body as well. 3) Moreover the separation of executive powers and functions in municipal government **cannot** accommodate the existence of an independent finance officer responsible to the municipal council or its executive committee. 4) This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.
Accounting System	1) Municipal accounting and budget format have been criticised as neither simple nor comprehensible, sometimes providing inadequate information and at other times a surfeit of information. 2) Both these situations are not **conducive to a proper system** of management information.

AUDIT PROGRAMME FOR LOCAL BODIES

Appointment

The **Local Fund Audit Wing of the State Govt. is generally in-charge of the audit of municipal accounts**. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc. have power to **appoint their own auditors for regular external audit**. So, **the auditor should ensure his appointment.**

Auditor's Concerns

The auditor while auditing the local bodies should **report** on the

a) **Fairness** of the contents and presentation of financial statements,

b) The **strengths and weaknesses** of system of financial control,

c) The **adherence** to legal and/or administrative requirements;

d) Whether **value** is being **fully received** on money spent.

e) To **detect errors and fraud and misuse of resources.**

Rules & Regulations

The auditor should ensure that the **expenditure incurred conforms to the relevant provisions of the law** and is in accordance with the financial rules and regulations framed by the competent authority

Authorizations

He should ensure that **all types of sanctions, either special or general, accorded by the competent authority.**

Provisioning

He should ensure that there is a **provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.**

Performance

The auditor should check that the **different schemes, programmes and projects**, where large financial expenditure has been incurred, are **running economically and getting the expected results.**

OBJECTIVE OF AUDIT OF LOCAL BODIES

1) The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However, the municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit.
2) **The important objectives of audit are:**
   a) **Reporting on the fairness of the content and presentation of financial statements;**
   b) **Reporting upon the strengths and weaknesses of systems of financial control;**
   c) **Reporting on the adherence to legal and/or administrative requirements;**
   d) **Reporting upon whether value is being fully received on money spent; and**
   e) **Detection and prevention of error, fraud and misuse of resources.**
3) Audit is another method of financial control on local governments. This provision is coupled with the privilege of ultra vires. An action of the local authority if it is beyond legal authority can result in 'surcharge' by audit.
4) In addition to the external audit, it is also opined by the learned author that there should be a system of internal audit in all municipal institutions. Internal audit should be provided by the institutions' own staff. It should be performed on a continuous basis according to a well-defined programme.
5) The external auditor should be able to rely upon the work of the internal audit as forming part of a complete system of internal financial control. Where there is no internal audit, as may happen in the case of small or poorly staffed municipalities, the external auditor himself has to do detailed checking.
6) As described under government audit increasing attention is being given, to what is described as **'value for money'** audit. This kind of audit focuses upon assessment of whether urban institutions are fulfilling their responsibilities with efficiency, economy and effectiveness (sometimes known as **'the three Es'**).

AUDIT OF NON-GOVERNMENTAL ORGANIZATION (NGO'S)

Background

a) **NGOs** can be defined as **non-profit making organizations which raise funds from members, donors or contributors** apart from receiving donation of time, energy and skills **for achieving their social objectives** like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situation.

b) Therefore, this definition of NGO would include religious organizations, voluntary health and welfare agencies, **charitable organizations, hospitals, old age homes, research foundations etc**. The scope of services rendered by NGOs is extremely wide and as such cannot be covered in a small definition.

c) Some examples of NGOs operating in India include **Child Relief and You (CRY), NORAD, UNICEF, Godhuli, Vidya, Concern India Foundation., etc.**

d) Non-Governmental Organisations are generally incorporated as **societies** under the **Societies Registration Act, 1860** or as **a trust** under the **India Trust Act, 1882**, or under any other law corresponding to these Laws enforced in any part of India.

e) NGOs can be incorporated as a company under **section 8** of the Companies Act, 2013.

f) None of the above mentioned Act warrant a mandatory registration under them for an NGO. But if an NGO is created as **a trust and trust relates to immovable property** worth more than **one hundred rupees**, the provision of **Section 17(1)** of the Registration Act, 1908 read with **Section 123 of the Transfer of Property Act, 1882** must be complied with and the registration of trust becomes mandatory.

g) In some states, such as the **states of Maharashtra and Gujarat**, where Public Trusts Acts have been passed, such as the **Bombay Public Trusts Act 1950**, all charitable trusts have to be registered under these specific Public Trusts Acts. Registration under **the Income Tax Act, 1961 and the Foreign Contribution (Regulation) Act, 2010** would also be invoked in many cases.

h) NGOs registered under the Companies Act, 2013 must **maintain their books of account** under the accrual basis as required by the provisions of **section 128 of the said Act**. If the accounts are **not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 2013.**

i) **The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either an accrual basis or cash basis.**

Sources and Applications of Funds

a) The **main sources of funds** include grants and donations, fund raising programmes, advertisements, fees from the members, technical assistance fees / fee for services rendered, subscriptions, gifts, sale of produce or publications, etc.

b) Donations and grants received in the **nature of promoter's contribution are in the nature of capital receipts and shown as liabilities in the Balance Sheet of NGO**. These may either be in the form of **corpus contribution or a contribution towards revolving fund**. A contribution made towards the capital or the corpus of an NGO is known as corpus contribution.

c) The donors are generally required to specify whether the donation/grant given by him shall form part of the corpus of the NGO. Such contributions are generally given with reference to the total funds required by an NGO.

d) **Section 11(1)(d) of the Income Tax Act 1961** also states that income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the computation of total income.

e) The objective of a contribution or grant towards a Revolving Fund is to **rotate the amount by giving temporary loans** from the fund to other NGO or beneficiaries for their projects and then recover the loan so as to give temporary loans again and so on.

f) However, any **interest earned from the beneficiary** on such temporary loans from the revolving fund could be **either added back to the fund or credited to the Income and Expenditure Account** depending on restrictions laid down by the authority providing the contribution (for the revolving fund) or by the rules and regulations laid down by the concerned NGO in this regard.

g) Donations and grants received for acquisition of **specific** fixed assets are those grants whose **primary condition** is that an NGO accepting them should purchase, construct or otherwise acquire the assets for which the grant is given.

h) Many a times NGOs receive contributions in kind. These contributions include assets such as land, buildings, vehicles, o ce equipment, etc. and articles related to programmes / projects such as food, books, building materials, clothes, beds, and raw material for training purposes, e.g., Wool, reeds, cloth, etc.

i) The **areas of application of funds** for an NGO include Establishment Costs, O ce and Administrative Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations and Contributions given, etc.

Provisions Relating to Audit

a) The **auditors of an NGO registered under the Societies Registration Act, 1860** (or under any law corresponding to this Act, in force in any part of India) or **the Indian Trusts Act 1882** are normally **appointed by the Management of the Society or Trust.**

b) **The auditors of NGO registered under section 8 of the Companies Act, 2013 are appointed by the members of the company.**

c) Some of the statues such as the Companies Act, 2013, Foreign Contribution (Regulation) Act 1976, Income Tax Act 1961 required that the accounts of the NGO be audited and submitted to the prescribed authorities and failure to do so could lead to forfeiture of certain exemptions and benefits. **In the case of NGO/PDA's di erent statutes have specified certain audit reports.**

d) The **Foreign Contribution (Regulation) Act 1976** has prescribed the format and requires that the same be furnished to the **Ministry of Home Affairs within 60 days from the close of the financial year i.e. by May 30 each year.**

While planning the audit, the auditor may concentrate on the following:

a) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operates.

b) **Updating knowledge of relevant statutes** especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the **Rules related to the statutes.**

c) **Reviewing the legal form of the Organization** and its Memorandum of Association, Articles of Association, Rules and Regulations.

d) Reviewing the **NGO's Organization chart**, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.

e) **Examination of minutes** of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.

f) **Study the accounting system, procedures, internal controls and internal checks** existing for the NGO and verify their applicability.

g) **Setting of materiality levels for audit purposes.**

h) **The nature and timing of reports or other communications.**

i) **The involvement of experts and their reports.**

j) **Review the previous year's Audit Report.**

The **audit programme** should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.

a) **Corpus Fund:** The contributions / grants received towards corpus be **vouched with special reference to the letters from the donor(s)**. The interest income be checked with Investment Register and Physical Investments in hand.

b) **Reserves:** Vouch transfers from projects / programmes with donor's letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.

c) **Ear-marked Funds:** (Earmarking refers to a fund allocation practice in which an entity, a government, or an individual sets aside a determined amount of funds to use for a specific goal). Check requirements of donor's institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.

d) **Project / Agency Balances:** Vouch disbursements and expenditure as per agreements with donors for each of the balances.

e) **Loans:** Vouch loans with loan agreements, counterfoil of receipt issued.

f) **Fixed Assets:** Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.

g) **Investments:** **Check Investment Register** and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis- investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.

h) **Cash in Hand:** **Physically verify the cash in hand** and imprest balances, at the close of the year and whether it tallies with the books of account.

i) **Bank Balance:** Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

j) **Inventory:** Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.

k) **Programme and Project Expenses:** Verify agreement with donor / contributor(s) supporting the particular programme or project to **ascertain the conditions with respect to undertaking** the programme/project and accordingly, in the case of programmes / projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

l) **Establishment Expenses:** Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other o ce and administrative expenses such as postage, stationery, travelling, etc.

The receipt of income of NGO may be checked on the following lines:

a) Contributions and Grants for projects and programmes: Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

b) Receipts from fund raising programmes: Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

c) Membership Fees: Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

d) Subscriptions: Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. Check the receipts with subscription rate schedule.

e) Interest and Dividends: Check the interest and dividends received and receivable with investments held during the year.

AUDIT OF SOLE TRADER

1) A sole trader is under no legal obligation to have his accounts audited. However, many such individuals get their financial statement audited due to regulatory requirements, such as inventory brokers or on a specific instructions of the bank for approval of loans, etc.

2) **Appointment of Auditor:** Auditors of sole- proprietary concern shall be appointed by the sole proprietor himself. In case of change of auditor, it would be duty of incoming auditor to communicate with the previous auditor. As such, sole proprietor can determine the scope of the audit as well as the conditions under which it will be carried out.

3) On these considerations, it is desirable that the contract of appointment of auditor in such a case should be in writing; also, that it should clearly define the scope of the work which the auditor is expected to carry out. This helps to prevent misunderstanding.

4) If the appointment of the auditor is not in writing, the auditor should write to his client explaining the scope of his duties. While doing so, he should state the limitations, if any, placed upon his work to obtain the client's confirmation.

5) The advantages and audit procedure discussed in following paragraphs of audit in case of partnership firm would be similar in case of proprietorship.

AUDIT OF FIRM

Appointment of Auditors

a) The auditor to a firm is usually **appointed by the partners** either on the basis of a decision taken by them or to comply with a condition in the partnership agreement.

b) **His remuneration is also fixed by the partners.**

c) It is important that the **letter of appointment should clearly state the nature and scope of audit** which is to be carried out and particulars of limitations, if any, under which he would have to function.

d) **In case of change of auditor, it would be duty of incoming auditor to communicate with the previous auditor.**

Matters to be considered before starting audit

Before starting the audit, he should examine the **partnership agreement** and note the provisions therein as regards the following matters:

a) The **name and style** under which the business shall be conducted.

b) The **duration of the partnership**, if any, that has been agreed upon.

c) The **amount of capital** that shall be **contributed** by each partner - whether it will be fixed or could be varied from year to year.

d) The **period** at the end of which the accounts of the partnership will be closed periodically and **the proportions** in which the profit shall be divided among the partners or losses shall have to be contributed by them; whether the losses shall be borne by the partners or whether any of the partners will not be required to do so.

e) The **provisions as regards maintenance of books of account** and the matters which must be taken into account for determining the profits of the firm available for division among the partners e.g., creation of reserves, provision for depreciation, etc. also the period within which accounts can be reopened for correcting a manifest error.

f) **Borrowing capacity** of the partnership (when it is not implied as in the case of non-trading firms).

g) **The rate** at which **interest** will be **allowed on the capitals** and loans provided by partners and the rate at which it will be charged on their drawings and current accounts.

h) Whether any **salaries are payable** to the partners or withdrawals are permitted against shares of profits and, if so, to what extent?

i) **Duties of the partners** as regards the management of business of the firm; also, the partners who shall act as managing partners.

j) **Who shall operate the bank account** of the firm? How will the surplus funds of the partnership be invested?

k) **Limitations and restrictions** that have been agreed upon, the rights and powers of partners and on their implied authority to pledge the firm's credit or to render it liable.

Advantages of Audit of a Partnership Firm

On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

a) **Disputes:** Audited accounts provide a **convenient and reliable means** of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.

b) **Dissolution:** On the **retirement or death of a partner**, audited accounts, which have been accepted by the partners, **constitute a reliable evidence for computing the amounts due to the retiring partner** or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.

c) **Reliable:** **Audited statement of accounts are relied upon by the banks** when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.

d) **Admission:** Audited statements of account can be **helpful in the negotiations** to admit a person as a partner, especially when they are available for a number of past years.

e) **Control:** An audit is an **effective safeguard against any undue advantage** being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

Matters which should be specially considered in the audit of accounts of a partnership

a) **Letter of Appointment:** **Confirming that the letters of appointment**, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.

b) **Partnership Documents:** **Studying the minute book**, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.

c) **Objects of Partnership:** **Verifying that the business in which the partnership is engaged is authorised by the partnership agreement**; or by any extension or modification thereof agreed to subsequently.

d) **Books of Account:** **Examining whether books of account appear to be reasonable** and are considered adequate in relation to the nature of the business of the partnership.

e) **Mutual Interest:** Verifying generally that the **interest of no partner has suffered prejudicially** by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.

f) **Provision for Taxes:** Confirming that a **provision for the firm's tax payable by the partnership** has been made in the accounts before arriving at the amount of profit divisible among the partners.

g) **Division of Profits:** Verifying that the **profits and losses have been divided among the partners in their agreed profit-sharing ratio.**

Note:

1) From the foregoing steps involved in the audit of a partnership it would be observed that like the audit of every other commercial undertaking, it culminates in the verification of the Balance Sheet and the Statement of Profit and Loss to ensure that these exhibit a true and fair state of a airs of the firm.

2) The object of examining the partnership agreement, which is an **important feature** of such an audit, is that the **auditor may be able to report to the partners if the interest of any partner has been prejudicially affected**, on account of the firm having engaged itself in an activity which it was not authorised to do or violation of any provision of the partnership agreement.

3) The auditor may, particularly, **ensure application of accounting standards** prescribed by the Institute.

4) In case the firm is required to get its accounts audited under the requirements of any statute, **the auditor will have to qualify the report in case of non-compliance with the accounting standards**.

5) Alternatively, **only disclosure of non-compliance with the accounting standards**, would be sufficient without making it a subject matter of qualification.

BASICS OF LIMITED LIABILITY PARTNERSHIPS (LLP) AUDIT

Distinctive Features of an LLP

a) LLP is governed by the Limited Liability Partnership Act 2008, which has come into force with effect from April 1, 2009. It is a form of business organisation which enshrines in itself the advantages of both the Company and Partnership forms of Organisation.

b) **Minimum of 2 Partners** can form an LLP and **atleast two partners would be Designated Partners** who would be required to take **DPIN (Designated Partner Identification Number)**.

c) The Partners in an LLP and **their rights and duties** are governed by way of an agreement between them.

d) **It defines a Small Limited Liability Partnership to denote any LLP:**

   i) the **Contribution** of which, **does not exceed twenty-five lakh rupees (INR 25,00,000)** or such higher amount, **not exceeding five crore rupees**, as may be prescribed; and

ii) the **Turnover** of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, **does not exceed forty lakh rupees (INR 40,00,000)** or such higher amount, not exceeding fifty crore rupees, as may be prescribed;

Books of accounts

An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. LLPs are required to maintain books of accounts which shall contain:

a) Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,

b) A record of the assets and liabilities of the LLP,

c) Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,

d) Any other particulars which the partners may decide.

Audit of the Accounts of an LLP

Rules provides that any LLP, whose **turnover does not exceed**, in any financial year, **forty lakh rupees**, or **whose contribution does not exceed twenty five lakh rupees**, is **not required to get its accounts audited**.

However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited.

Advantages / Purpose / Need of Audit

a) Detection of Errors: Auditing the accounts of a LLP **helps in detecting errors & frauds** & verification of financial statements.

b) **Disputes**: Disputes, if any between any partners in the **matter of accounts can be settled** with the help of audited accounts.

c) **Reliability**: Banks & financial institutions **lend money to the firms only on the basis of audited accounts**.

d) Better Compliance and Management: **Periodical visits & suggestions** by the auditor will be **helpful in improving the management of the LLP**.

e) Reconstitution: **For settling accounts between partners at the time of admission, death, retirement, insolvency, insanity, etc.** audited accounts are accepted by those concerned who have dealings with the LLP.

Appointment of Auditor

The auditor may be appointed by the designated partners of the LLP -

a) At any time for the first financial year but before the end of first financial year,

b) At least thirty days prior to the end of each financial year (other than the first financial year),

c) To fill the causal vacancy in the o ce of auditor,

d) To fill the casual vacancy caused by removal of auditor.

The partners may appoint the auditors if the designated partners have failed to appoint them.

Auditor's Duty Regarding Audit of LLP

1) **Engagement Letter**: The auditor should get definite instructions writing as to the work to be performed by him.
2) **Minutes Book:** If partners maintain minute book he shall refer it for any resolution passed regarding the accounts.
3) **LLP Agreement:** The auditor should read the LLP agreement & note the following provisions:
   a) Nature of the business of the LLP.
   b) Amount of capital contributed by each partner.
   c) Interest – in respect of additional capital contributed.
   d) Duration of partnership.
   e) Drawings allowed to the partners.
   f) Salaries, commission etc. payable to partners.
   g) Borrowing powers of the LLP.
   h) Rights & duties of partners.
   i) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
   j) Any loans advanced by the partners.
   k) Profit sharing ratio
4) **Reporting:** The auditor should mention
   a) Whether the records of the firm appear to be correct & reliable.
   b) Whether he was able to obtain all information & explanation necessary for his work.
   c) Whether any restriction was imposed upon him.

Returns to be maintained and filed by an LLP

a) Every LLP would be required to file annual return in **Form 11 with ROC within 60 days** of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.

b) Every LLP is also required to submit Statement of Account and Solvency in **Form 8** which shall be filed **within a period of 30 days from the end of six months** the financial year to which the Statement of Account and Solvency relates.

AUDIT OF CHARITABLE INSTITUTION

In the case of audit of a charitable institution, attention should be paid to the following matters

General

a) Studying the **constitution** under which the charitable institution has been set up.

b) Verifying whether the institution is being managed in the manner **contemplated by the law under which it has been set up**.

c) Examining the **system of internal check**, especially as regards accounting of amounts collected.

d) **Verifying** in detail the **income** and confirming that the amounts received have been deposited in the bank regularly and promptly.

e) Examine the **Trust Deed or the Regulations** as laid down.

Subscriptions and donations

Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year. Whether **official receipts** are issued;

a) Confirming that adequate control is imposed over unused receipt books;

b) Obtaining all receipt books covering the period under review;

c) Test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;

d) Obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;

e) Examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and

f) Verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

Legacies

Verifying the amounts received by reference to correspondence with any figures and other available information.

Grants

a) Vouching the amount received with the relevant correspondence, receipts and minute books.

b) Obtaining a certificate from a responsible official showing the amount of grants received.

Investments Income

a) Vouching the amounts received with the dividend and interest counterfoils.

b) Checking the calculations of interest received on securities bearing fixed rates of interest.

c) Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.

d) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

Rent

a) Examining the rent roll and inspecting tenancy agreements, noting in each case:

   (i) the amounts of the rents, and

   (ii) the due dates.

b) Vouching the rents on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.

Special function, etc.

Vouching gross receipts and outgoings in respect of any special functions, e.g. concerts, dramatic performance, etc., held in aid of the charity with such vouchers and cash statements as are necessary. In particular, verifying that the proceeds of all tickets issued have been accounted for, after making the allowance for returns.

Income Tax Refunds

Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax. This involves:

a) Vouching the Income-tax refund with the correspondence with the Income- tax Department; and

b) Checking the calculation of the repayment of claims.

Expenditure

a) Vouching payment of grants, also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the Managing Committee has benefited there from either directly or indirectly.

b) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test- basis.

c) Verifying the cash and bank balances.

d) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

AUDIT OF EDUCATION INSTITUTION (SCHOOL, COLLEGE & UNIVERSITY)

The special steps involved in their audit are the following -

General

a) **Examine the Trust Deed or Regulations**, in the case of school or college and note all the provisions affecting accounts. **In the case of a university, refer to the Act of Legislature and the Regulation framed thereunder.**

b) **Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts** to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

Fee from Students

a) **Check names entered in the Students Fee Register** for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and **verify that there operates a system of internal check which ensures that demands against the students are properly raised.**

b) **Check fees received by comparing counterfoils of receipts** granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

c) **Total up the various columns of the Fees Register for each month** or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written o under the sanction of an appropriate authority.

d) **Check admission fees with admission slips signed by the head of the institution** and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.

e) **See that free studentship and concessions have been granted by a person authorised** to do so, having regard to the Rules prepared by the Managing Committee.

f) **Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.**

g) **Confirm that hostel dues were recovered** before student's accounts were closed and their deposits of caution money refunded.

Other Receipts/Grants & Donations

a) **Verify rental income from landed property with the rent rolls, etc.**

b) **Vouch income from endowments and legacies**, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

c) **Verify any Government or local authority** grant with the memo of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons thereof.

Expenditure

a) **Verify that the Provident Fund money of the staff has been invested in appropriate securities.**

b) **Vouch donations**, if any with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

c) **Vouch, all capital expenditure** in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

d) Vouch, in the usual manner, all establishment expenses and enquire into any unduly heavy expenditure under any head. If there was any annual budget prepared, see that any excess under any head over the budgeted amount was duly sanctioned by the Managing Committee. If not, bring it to the Committee's notice in your report.

e) **See that increase in the salaries of the sta have been sanctioned and noted by the Committee.**

Assets & Liabilities

a) **Report any old heavy arrears** on account of fees, dormitory rents, etc. to the Managing Committee.

b) Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet not transferred to revenue, unless they are not refundable.

c) See that the **investments representing endowment funds for prizes are kept separate** and any income in excess of the prizes has been accumulated and invested along with the corpus.

d) **Ascertain that the system** ordering inspection on receipt and issue of provisions, foodstu s, clothing and other equipment is **e cient and all bills are duly authorised and passed before payment**.

e) Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be **checked by reference to Inventory Register** or corresponding inventories of the previous year and values applied to various items should be test checked.

Compliances

a) **Confirm that the refund of taxes deducted from the income from investment** (interest on securities etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

b) Finally, **verify the annual statements of account** and, while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of staff, etc.

AUDIT OF HOSPITAL

The special steps involved in such an audit are stated below -

1) **Register of Patients:**

   Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

2) **Collection of Cash:**

   Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patient's bill, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

3) **Income from Investments, Rent etc.:**

   See with reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.

4) **Legacies and Donations:**

   Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

5) **Reconciliation of Subscriptions:**

   Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

6) **Authorisation and Sanctions:**

   Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to sta have been duly authorised.

7) **Grants and TDS:**

   Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

8) **Budgets:**

   Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.

9) **Internal Check:**

   Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

10) **Depreciation:**

See that depreciation has been written o against all the assets at the appropriate rates.

11) **Registers:**

Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

12) **Inventories:**

Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

13) **Management Representation and Certificate:**

Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

AUDIT OF CLUB

The special steps involved in such an audit are stated below -

1) **Entrance Fee:**

Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a **reference to minutes of the Managing Committee.**

2) **Subscriptions:**

Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.

3) **Arrears of Subscriptions:**

Ensure that **arrears of subscriptions for the previous year have been correctly brought over** and arrears for the year under audit and **subscriptions received in advance have been correctly adjusted.**

4) **Arithmetical accuracy:**

Check totals of various columns of the Register of members and tally them across.

5) **Irrecoverable Member Dues:**

See the **Register of Members** to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.

6) **Pricing:**

Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.

7) **Member Accounts:**

Trace **debits for a selected period from subsidiary registers** maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.

8) **Purchases:**

Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.

9) **Margins earned:**

Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be **verified physically and its valuation checked**.

10) **Inventories:**

Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of the year.

11) **Investments:**

Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.

12) **Management Powers:**

Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

AUDIT OF CINEMA HALL

The special steps involved in its audit are stated below -

1) Verify the **internal control mechanism**:
   a) That entrance to the cinema-hall during show is only through printed tickets;
   b) That they are serially numbered and bound into books;
   c) That the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;
   d) That for advance booking a separate series of tickets is issued; and
   e) That the inventory of tickets is kept in the custody of a responsible official.
2) Confirm that at the end of show, a **statement of tickets sold is prepared and cash collected is agreed with it**.
3) Verify that a record is kept of the **'free passes'** and that these are issued under proper authority.
4) **Reconcile the amount of Tax collected** with the total number of tickets issued for each class and vouch and verify the entertainment tax returns filed each month.
5) **Vouch the entries in the Cash Book** in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as

aforementioned with record of tickets issued for the di erent shows held.

6) Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.
7) Vouch the expenditure incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalized.
8) Confirm that depreciation on machinery and furniture has been charged at an appropriate rate.
9) Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.
10) Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.
11) The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstu s, purchase of foodstu s, cold drink, etc. as in the case of club.

AUDIT OF HIRE PURCHASE COMPANY

1) Hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which-
   a) Possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments,
   b) The property in the goods is to pass to such person on the payment of the last of such instalments, and
   c) Such person has a right to terminate the agreement at any time before the property so passes.
2) Thus, hirer means the person who obtains or has obtained possession of goods from an owner under a hire- purchase agreement and owner means the person who lets or has let, delivers or has delivered possession of goods to a hirer under a hire-purchase agreement in order to complete the purchase of, or the acquisition of property in the goods of which the agreement relates; and includes any sum so payable by the hirer under the hire- purchase agreement by way of a deposit or other initial payment.
3) While checking the hire- purchase transaction, the auditor may examine the following:
   a) Hire purchase agreement is in writing and is signed by all parties.
   b) Hire purchase agreement specifies clearly-

(i) The hire-purchase price of the goods to which the agreement relates;

(ii) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;

(iii) The date on which the agreement shall be deemed to have commenced;

(iv) The number of instalments by which the hire- purchase price is to be paid, the amount of each of those instalments, and the date, or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable; and

(v) The goods to which the agreement relates, in a manner su cient to identify them.

c) Ensure that instalment payments are being received regularly as per the agreement.

AUDIT OF LEASING COMPANIES

1) In a lease agreement, a party (called 'lessee') acquires the right to use an asset for an agreed period of time in consideration of payment of rent to another party (called 'lessor').

2) In certain lease agreements, the legal ownership of the asset remains with the lessor (the leasing company), but in substance, all the risks and rewards of ownership of the asset are transferred to the lessee.

3) In other words, the lease is, in e ect, a financing arrangement. Such leases are termed as finance leases. An operating lease, on the other hand, is a simple arrangement where, in return for rent, the lessor allows the lessee to use the asset for a certain period.

4) A normal financial lease transaction usually goes through the following modality:

a) The lessee will select the equipment, and satisfy himself about its functional fitness and specifications, the lessor has no participation at this stage.

b) Having chosen the equipment, the lessee approaches a lessor, either directly or through a lease-broking agency.

c) The lease agreement is broadly negotiated and the rates are finalised. The lessor places an order on the manufacturer as chosen by the lessee.

d) The manufacturer delivers the equipment at the site of the lessee, and the latter gives notice of acceptance to the lessor.

e) The lease agreement giving detailed terms of contract is signed between the parties. Leases will normally be full pay-out, with term varying as per requirements.

f) During the lease period, the lessee:

(i) Will pay rentals regularly at periods agreed-upon, which are usually each calendar month;

(ii) Will keep the equipment in good repair and working condition, etc.

(iii) Will be entitled to any manufacturer's warranties or after-sales services.

g) At the end of the lease period, the equipment shall retreat to the lessor. The lessee may, however, be given a renewal right, or may be allowed to participate in purchase of the equipment when the lessor intends to sell it. No purchase option shall be given to the lessee in the lease agreement itself.

Auditor's Procedures

In respect of leasing transaction entered into by the leasing company, the following procedures may be adopted by the auditor:

1) The **object clause of leasing company** to see that the goods like capital goods, consumer durables etc. in respect of which the company can undertake such activities. Further, to ensure that whether company can undertake financing activities or not.
2) **Whether there exists a procedure to ascertain the credit analysis of lessee** like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security, etc.
3) The lease agreement should be examined and the following points may be noted:
   a) **The description of the lessor, the lessee, the equipment and the location** where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
   b) **The amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.**
   c) **Whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.**
   d) **Whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.**
4) Examine the lease proposal form submitted by the lessee requesting the lessor to provide him the equipment on lease.
5) Ensure that the **invoice is retained safely** as the lease is a long-term contract.
6) **Examine the acceptance letter** obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.
7) **See the Board resolution** authorising a particular director to execute the lease agreement has been passed by the lessee.
8) See that the **copies of the insurance policies** have been obtained by the lessor for his records.

Note:

Students need to pay attention that AS-19/ Ind-AS 17 define that lease arrangements could be of 2 types i.e. Finance Lease and Operating Lease.

Finance Lease

An arrangement with the following attributes qualifies as a Finance Lease:

a) The lease arrangement **transfers ownership of the asset** to the lessee at the end of the lease term;

b) The **lessee has the option to purchase the asset** at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

c) The **lease term is for the major part of the economic life of the asset** even if title is not transferred;

d) At the inception of the lease, **the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;** and

e) the **leased assets are of such a specialized nature** that only the lessee can use them without major modifications.

Operating Lease

An arrangement that **does not transfer substantially all the risks and rewards** incidental to ownership qualifies as an Operating Lease. In other words, an operating lease is a lease arrangement "**Other than finance lease**".

The below table captures the broad di erences under both the above said types of lease arrangements:

Points	Operating Lease	Financial Lease
Common examples	Lease of Projector, Computers, Laptops, Coffee Dispensers etc.	Lease of Plant and Machinery, Land, Office Building etc.
Ownership	Ownership of the asset remains with the lessor for the entire period of lease.	Ownership transfer option at the end of the lease period is with the lessee. Title may or may not be eventually transferred.
Accounting treatment	Operating lease is generally treated like a renting arrangement. That means, the lease payments are treated as operating expenses and the asset does not appear as an asset on lessee's balance sheet.	Financial lease is treated like loan arrangement. Hence, the asset ownership is considered of that of the lessee and thus appears on the balance sheet of the lessee.
Purchase Option	Under operating lease, the lessee does not have any option to buy the asset during the lease period.	Financial lease allows the lessee to have a purchase option at less than the fair market value of the asset.

Lease Term	Lease term generally extends to less than 75% of the projected useful life of the leased asset.	Lease term is generally more than or equal to estimated economic life of the asset under the lease arrangement.
Operating/ running expenses	Lessee pays only the monthly lease payments. No running or administration costs are to be borne for example: registration, repairs etc. since it gives only right to use the asset.	Lessee generally bears insurance, maintenance and taxes.
Tax benefit	Since operating lease is as good as renting, lease payment is considered as expense. No depreciation can be claimed by the lessee.	Lessee can claim both interest and depreciation expense as financial lease is treated like a loan.

AUDIT OF HOTELS

The special considerations in a hotel audit can be summarised as follows:

Internal Controls

a) **Pilfering is one of the greatest problems in any hotel** and the importance of internal control cannot be undermined.

b) It is the **responsibility of management to introduce controls** which will minimise the leakage as far as possible.

c) Evidence of their success is provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated.

d) The auditor should **obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations**.

e) The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.

f) The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities.

g) **If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor.**

h) As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts.

i) As a result, **the scope of his audit tests will necessarily be increased** and, **in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.**

Room Sales & Hall Bookings

a) The **charge for room sales is normally posted to guest bills** by the receptionist/ front office or in the case of large hotels by the night auditor.

b) The source of these entries is invariably the guest register and **audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period**.

c) Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.

d) In many hotels, the **housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room**.

e) This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.

f) The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.

g) The auditor should ensure that proper records are maintained for booking of halls and other premises for special parties and recovered on the basis of the tari .

Inventories

a) The inventories in any hotel are both **readily portable and saleable** particularly the food and beverage inventories.

b) It is therefore **extremely important that all movements and transfers of such inventories** should be properly documented to enable control to be exercised over each individual stores areas and sales point.

c) The auditor should carry out tests to ensure that all such documentation is accurately processed.

d) Areas where large quantities of inventory are held should be kept locked, the key being retained by the departmental manager.

e) The key should be released only to **trusted personnel and unauthorised persons should not be permitted in the stores areas except under constant supervision**. In particular, any movement of goods in or out of the stores should be checked. Many hotels use specialised **professional valuers to take and value the inventories on a continuous basis throughout the year**.

f) Such a valuation is then almost invariably used as the basis of the balance sheet inventory figure at the year end. Although such valuers are independent of the audit client, it is important that the auditor satisfies himself that the **amounts included for such inventories are reasonable**.

g) In order to satisfy himself of this, the auditor should **consider attending the physical inventory taking** and **carrying out certain pricing and calculation tests**. The extent of such tests could well be limited since the figures will have been prepared independently of the hotel.

Fixed Assets

a) The accounting policies for fixed assets of individual hotels are likely to differ. However, many hotels account for certain **quasi-fixed assets** such as silver and cutlery on inventory basis.

b) This can lead to confusion between each inventory items and similar assets which are **accounted for on a more normal fixed assets basis**.

c) In such cases, it is important that very detailed definitions of inventory items exist and the auditor should carry out tests to ensure that the definitions have been closely followed.

d) The auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, whereas costs of major alterations and additions to the hotel building and facilities capitalized.

Casual Labour

a) The hotel trade operates to **very large extent on casual labour**. The records maintained of such wage payments are **frequently inadequate**.

b) The auditor should ensure that **defalcation on this account does not take place** by suggesting proper controls to the management.

Travel Agents & Shops

a) For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies. The auditor should ensure that **money is recovered from the travel agents or booking agencies as per the terms of credit allowed**.

b) **Commission**, if any, paid to travel agents or booking agents **should be checked by reference to the agreement on that behalf**.

The Dayal Singh College an institution managed by Dayal Trust, has received a grant of 2 crore from Government nodal agencies for funding a project of research on rural health systems in India.

Draft an audit programme for auditing this fund in the accounts of the college.

Answer:

1) The auditors should obtain preliminary knowledge about the college & the trust.
2) He should carefully study the grant letter to understand the conditions relating to grant.
3) He should examine the bank statement & trace the receipt of grant therein.
4) He should enquire the management about budgeted project expenditure & actual expenditure so far.
5) He should ascertain the progress of the project from minutes book.
6) It should also be ensured that project fund is actually being used for the intended purpose

only.

7) Examine whether purchase of capital assets have been appropriately capitalized.
8) He should ensure that physical verification of the assets relating to fund is carried out by the management.
9) The revenue expenditures from the grant must be checked to ensure their proper accounting. He should also examine relevant vouchers.
10) Finally, he should examine whether fund account has been shown as a liability separately in the balance sheet.

GOVERNMENT AUDIT

INTRODUCTION

Government audit means

The **objective**, **systematic**, **professional** and **independent** examination of **financial**, **administrative and other operations** of a Public Entity, made subsequently to their execution for the purpose of **evaluating and verifying** them, Presenting a report with **comments on audit findings together with conclusions & recommendations for future actions by the responsible officials** and in case of **examination of financial statements expressing the appropriate professional opinion regarding the fairness of the presentation**.

Objectives

a) **Accounting for Public Funds:** Government audit serves as a mechanism or process for public accounting of government funds.

b) **Appraisal of Government policies:** It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the o cials administering them.

c) **Base for Corrective actions:** Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level o cers to take corrective measures.

Administrative accountability Note:

(i) Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end.

(ii) The main objective of audit is a **combination of** ensuring **accountability of administration to legislature and functioning as an aid to administration**.

(iii) In India, the function of Government Audit is discharged by the **independent statutory authority of the Comptroller and Auditor General** through the agency of **the Indian Audit and Accounts Department**.

(iv) Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executives of the spending agencies to the sanctioning or controlling authorities. The purpose or objectives of audit need to be tested at the touchstone of public accountability.

(v) The Comptroller and Auditor General (C&AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

COMPTROLLER & AUDIT GENERAL OF INDIA

Appointment

The **President of India** shall appoint CAG.

Removal or resignation

a) He can be removed from the office only on the ground of **proven mis-behaviour or incapacity**.

b) Moreover, he can be removed from office only when each house of parliament decides to do so by a **majority of at least two third of the members** present and voting.

c) He can **resign any time** through a resignation letter addressed to the President of India.

Remuneration & Tenure

a) He shall be paid a salary **equivalent to that of a Judge of the Supreme Court.**

b) The parliament is competent to make laws to determine salary and other conditions of service.

c) He shall hold office for **six years** or **up to age of 65 years, whichever is earlier**.

Various Constitutional Provisions

a) **Article 149** states that the C&AG shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States and of any other authority or body as may be prescribed by or under any law made by the Parliament. The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 defines these functions and powers in detail.

b) **Article 150** of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

c) **Article 151** requires that the reports of the C&AG relating to the accounts of the Union/State shall be submitted to the President/Governor who shall cause them to be laid before House of Parliament/State Legislature.

DUTIES OF COMPTROLLER & AUDITOR GENERAL

Compilation and Submission of Accounts	He shall **compile the accounts** of the **Union/State/Union Territory** and submit those accounts to the **President / Governor / Administrator** respectively.

Audit of Receipts and Expenditure	He shall audit and report on all **receipts and expenditure** of any body, which has been **substantially financed** from the Consolidated Fund of India/State/Union Territory. **Note:** A body or authority shall be treated as **substantially financed** if the amount of grant or loan **in one year is not less than;** i) **₹ 25 lakhs, and** ii) **75% of the total expenditure of that body or authority.**
Audit of Grants or Loans	a) Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory hto any authority or body, not being a foreign State or international organization. b) The Comptroller and Auditor General shall **scrutinize the procedures** by which the sanctioning authority **satisfies itself as to the fulfillment of the conditions** subject to which such grants or loans were given and shall for this purpose have **right of access**, after giving reasonable previous notice, **to the books and accounts of that authority or body.**
Audit of receipts of Union or States	The CAG shall **review rules and procedures** designed to secure an **effective check on assessment, collection and proper allocation of revenue**, for all receipts payable into Consolidated fund of India/Sate/Union Territory.
Audit of Accounts of Stores and Inventory	The CAG shall have the authority to **audit and report on the accounts of stores and inventory** kept in any office or department of the union or state.
Audit of Government Companies & Corporations	CAG shall exercise powers and observe duties as per the provisions of the **Companies Act, 2013** in relation to the **Government Companies or Corporations.**
General provisions relating to Audit	It shall be the duty of the Comptroller and Auditor General - a) To audit and report on **all expenditure from the Consolidated Fund of India** and of each State and of each Union Territory having a Legislative Assembly and to **ascertain whether the moneys shown in the accounts as having been disbursed were legally available** for and applicable to the service or purpose to which they have been applied or charged and **whether the expenditure conforms to the authority**

	which governs it; b) To audit and report all **transactions of the Union and of the States relating to Contingency Funds and Public Accounts;** c) To audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

POWERS OF COMPTROLLER & AUDITOR GENERAL

Inspection	To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.
Transmission	To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.
Inquiry and Call for Information	To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.
Sample check	In carrying out the audit, the Comptroller and Auditor General has the power a) **To dispense with any part of detailed audit of any accounts or class of transactions and** b) **To apply such limited checks in relation to such accounts or transactions as he may determine.**

EXPENDITURE AUDIT

The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which ex-penditure can be incurred. These standards are—

(i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the **audit against 'rules and orders'**.

(ii) that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the **audit of sanctions**.

(iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as **audit against provision of funds**.

(iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as **propriety audit**.

(v) that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the **performance audit**.

AUDIT AGAINST RULES AND ORDERS (REGULARITY AUDIT)

1) **Its objective is to ensure whether the expenditure is in accordance with:**
   a) **relevant provisions of the Constitution** and of the **laws and rules**.
   b) the **financial rules, regulations** issued by CAG.
   c) the orders of, or rules made by, any competent authority.
2) Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these,however, does not vest with the C&AG.
3) **These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:**
   a) Rules and orders regulating the powers to **incur and sanction expenditure** from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);
   b) Rules and orders dealing with the **mode of presentation of claims against government, withdrawing moneys** from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the Financial rules **prescribing the detailed procedure** to be followed by government servants in dealing with government transactions; and
   c) Rules and orders **regulating the conditions of service**, pay and allowances, and pensions of government servants.
4) It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be.
5) **But, it is the function of Audit to carry out examination of the various Rules, Regulations and orders issued by the executive authority to see that:**
   a) they are not inconsistent with any provisions of the Constitution or any laws made there under;
   b) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;
   c) they do not come in conflict with the orders of, or rules made by, any higher authority; and

d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

AUDIT OF SANCTIONS

1) The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority.
2) The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

AUDIT AGAINST PROVISION OF FUNDS

Its objective is to ensure whether the expenditure:

a) Is made for the purpose to which the grant and appropriation has been provided.

b) Does not exceed the appropriation made.

AUDIT OF PROPRIETY

1) According to 'Propriety audit', the auditors try to bring out cases of improper, avoidable, or ineffective expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.
2) With the passage of time, it was felt that regularity audit alone was not sufficient to protect properly the public interest in the spending of money by the executive authorities.
3) A transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned but may still be highly wasteful.

   For Example: A building may be constructed for installing a telephone exchange but may not be used for the same purpose resulting in unproductive expenditure or a school building may be constructed but used after five years of its completion is a case of avoidable expenditure.
4) Auditor should try to examine public financial morality by looking into the wisdom, faithfulness and economy of transactions.
5) It is hard to frame any precise rules for regulating the course of audit against propriety. Such an objective of audit depends for its acceptance on its appeal to the common sense and straight logic of the auditors and of those whose financial transactions are subjected to propriety audit.
6) However, some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

a) The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

b) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

c) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(i) The amount of expenditure involved is insignificant; or

(ii) A claim for the amount could be enforced in a Court of law; or

(iii) The expenditure is in pursuance of a recognised policy or custom; and

(iv) The amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Note:

It is the responsibility of the executive departments to enforce economy in public expenditure. The function of audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper, avoidable and ineffective / unproductive expenditure.

PERFORMANCE AUDIT

1) It involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the performance audit.

2) The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit:

3) Efficiency audit:

It looks into whether the various schemes / projects are executed and their operations conducted economically and whether they are yielding the results expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner.

4) Economy audit:

It looks into whether government have acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.

5) Effectiveness audit:

a) It is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives.

b) **Efficiency-cum-performance audit**, wherever used, is an objective examination of the Financial and operational performance of an **organisation, programme, authority or function** and is oriented towards identifying **opportunities for greater economy**, and effectiveness.

c) The procedure for conducting performance audit covers:
   (i) Identification of topic,
   (ii) Preliminary study,
   (iii) Planning,
   (iv) Execution of audit, and
   (v) Reporting.

AUDIT OF COMMERCIAL ACCOUNTS

Public enterprises are required to maintain commercial accounts and are generally classified under three categories:

a) **departmental enterprises** engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other government departments and agencies;

b) **statutory bodies, corporations**, created by specific statutes mostly financed by government in the form of loans, grants, etc. and

c) **government companies** set up under the Companies Act, 2013.

The audit of:

a) **Departmental concerns** is undertaken in the same manner as any department of government where commercial accounts are kept.

b) **Statutory bodies or corporations** depends on the nature and type of the statute governing the bodies or corporations. Both financial and accounts audit are conducted by the C&AG, and where compilation of accounts is vested with the C&AG, functions, norms and standards of works usually followed by the professional auditors are adopted mutatis mutandis.

c) **Government companies**
   (i) It is conducted by their own auditors under the statute appointed by C&AG. In addition, the C&AG conducts a supplementary test audit of the accounts, as well as periodical financial audit and appraisal of performance.
   (ii) The C&AG also issues direction to the company auditors for reporting on specific aspects of their audit work. These are reviewed, and condensed in the audit reports to the government/legislatures.
   (iii) C&AG has adopted the mechanism of an Audit Board-comprising of representatives of the audit and nominees of government including functional specialists to process reviews or appraisals on performance.

Note:

Refer Role of C&AG prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013 in Chapter – 8 "Audit Report".

AUDIT OF STORES AND INVENTORIES

Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG.

Audit is conducted:

1) to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.
2) to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.
3) to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.
4) to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.
5) to check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence.
6) When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time.
7) The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

AUDIT OF RECEIPTS

The audit of receipts is neither all pervasive or as old as audit of expenditure but has come to stay in some countries. Such an audit provides for checking:

1) Whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;
2) Whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;

3) Whether such regulations and procedures are **actually being carried out**;
4) Whether adequate checks imposed to **ensure the prompt detection and investigation** of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or willful omission or negligence to levy or collect taxes or to issue refunds; and
5) Review of systems and procedures to see that the internal procedures adequately secure correct and **regular accounting of demands collection and refunds** and pursuant of dues up to final settlement and to suggest improvement.
6) The **extent and quantum of audit** required to be done under each category of audit are determined by the C&AG. These are **neither negotiable nor questioned**.
7) The prescribed extent and quantum of audit are structured in accordance with the design of test check, random sampling, general review, in-depth study of specified areas, etc. as may be warranted by the nature of transactions, its importance in the scheme of activities of a department and the totality of its transactions, the frequency of check and total plan of audit to be executed during a period.
8) Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy.

REPORTING PROCEDURES

1) The effectiveness of an audit depends **on reporting results to the proper authority** so that appropriate action may be taken to rectify the irregularities or impropriety where possible or to prevent re-occurrence.
2) The right as also the obligation to report on the results of audit findings is inherent to the institution of the Auditor General and is usually safeguarded in the Constitution and related enactments.
3) **Article 151 of the Indian Constitution** enjoins that the C&AG shall report on the accounts of the Union and of each of the States to the President or the Governor concern and the **letter shall cause the report to be laid before the legislatures**.
4) **The reports should not only be presented to the legislatures** but thereafter also **publicised adequately in order to create a proper climate of public opinion** for taking remedial action where necessary, on the findings of the Auditor General. This may also constitute a more effective safeguard in the future.
5) In India, **the reporting is factual and the conclusions are left to be drawn by the reader**. This is presumably to ensure total objectivity. Nothing debars **C&AG from making recommendations** in the audit report but traditionally this has been left to be done by the Public Accounts Committee.

AUDIT OF CO-OPERATIVE SOCIETIES

INTRODUCTION

1) A cooperative (also known as co-operative, co-op, or coop) is an **"autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned enterprise"**.
2) **The Co-operative Societies Act, 1912,** a Central Act, contains the fundamental law regarding the formation and working of the co-operative societies in India and is applicable in many states with or without amendments. In many states, viz., Maharashtra, West Bengal, Orissa, the co-operative societies are governed by specific state Acts. An auditor of a co-operative society should be familiar with the provisions of the particular Act governing the society under audit.
3) Co-operative society is a business organization with a special mode of doing business, by pulling together all the means of production co-operatively, elimination of middlemen and exploitation from outside forces.
4) A chartered accountant has to play a significant role in the development of cooperative organisations on scientific lines. In this Unit, it is proposed to give a few guidelines in the matter of audits of co-operative societies.
5) Apart from audit, some other professional services could be rendered by chartered accountants such as -
   a) **Guidance in accounts writing,**
   b) **Installation of accounting system,**
   c) **Internal audit,**
   d) **Management accounting services,**
   e) **Taxation etc.**
6) However, the main focus is to give some guidelines about the audit of co-operative societies in general. The special features of audit applicable to all societies will be considered first, and subsequently a few special points with reference to audit programmes of specific types of societies will be considered.

AUDIT AS PER SECTION 17 OF CO-OPERATIVE SOCIETIES ACT, 1912

1) The **Registrar shall audit or cause to be audited by some person authorised by him** by general or special order in writing in this behalf the accounts of every registered society once **at least in every year**.
2) The audit under sub-section (1) **shall include an examination of overdue debts**, if any, and a **valuation of the assets and liabilities of the society**.
3) The Registrar, the Collector or any person authorised by general or special order in writing in this behalf by the Registrar shall **at all times have access to all the books, accounts, papers and securities of a society**, and **every officer of the society shall furnish such information in**

regard to the transactions and working of the society as the person making such inspection may require.

"Registrar" means a person appointed to perform the duties of a Registrar of Co- operative Societies under this Act.

IMPORTANT POINTS IN CO-OPERATIVE SOCIETY AUDIT

The following points should be kept in mind in connection with the audit of a co- operative society:

Qualifications of Auditors

Apart from a chartered accountant within the meaning of the Chartered Accountants Act, 1949, some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts or in co-operation and accountancy and also a person who has served as an auditor in the co-operative department of a government to act as an auditor.

Appointment of the Auditor

An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society. The audit fees are paid by the society on the basis of statutory scale of fees prescribed by the Registrar, according to the category of the society audited.

Books, Accounts and other records of Co-operative Societies

1) Under section 43(h) of the Central Act, a state government can frame rules prescribing the books and accounts to be kept by a co-operative society.

   For example, in Maharashtra, the co-operative societies are required to maintain books of account in terms of the instructions of the Registrar as following:

   a) All sums of money received and expended by the society and the matters in respect of which receipts and expenditure take place.

   b) All sales and purchases of goods by the society.

   c) Assets and liabilities of the society.

2) In order to maintain proper financial accounting records so as to disclose full financial results of working of the society, the statutory or mandatory provisions provide a directive, but they are not conclusive.

3) The society is at liberty to maintain such additional records according to its convenience and which it thinks more useful for clarity and detailed explanation. Ultimately the financial transactions and the results thereof must be presented very clearly and in the best possible manner.

4) Depending upon the nature and object of the society, di erent kinds of books and registers will be maintained, so as to disclose a proper and fair picture of financial transactions. In case of

large scale co-operative organisation, di erent subsidiary books and registers shall be maintained and the daily summary totals will be transferred to main Cash Book.

For example:

a) Daily cash sales summary register.

b) A register of collection from debtors if credit sales are allowed by bye-laws of society.

c) A register of recovery of loans from salaries and directly by receipts from members in case of credit society.

d) Loan disbursement register in case of credit society.

e) Any other columnar subsidiaries depending upon the nature and functions of society.

Restrictions on share holdings

a) According to **section 5 of the Central Act**, in the case of a society where the liability of a member of the society is **limited, no member** of a society other than a registered society can hold such **portion of the share capital** of the society as would **exceed a maximum of twenty percent of the total number of shares** or of the **value of shareholding to ` 1,000/-**

b) The auditor of a co-operative society will be concerned with this provision so as to watch any breach relating to holding of shares.

c) The State Acts may provide limits as to the shareholding, other than that provided in the Central Act.

Restrictions on loans

Section 29 of the Central Act puts restriction on loan. It states that a **registered society shall not make a loan to any person other than a member**. However, **with the special sanction of the Registrar**, a registered society **may make a loan to another registered society**.

The State government may further put such restrictions as it thinks fit on loaning powers of the society to its members or to other societies in the interest of the society concerned and its members.

Restrictions on borrowings

Section 30 of the Central Act further puts restriction on borrowings. According to this section, **a registered society shall accept loans and deposits from persons who are not members subject to the restrictions and limits of the bye-laws of the society**. The auditor will have to **examine the bye-laws in this respect**.

Investment of funds

According to **Section 32 of the Central Act**, a society may invest its funds in any one or more of the following:

a) In the **Central or State** Co-operative Bank.

b) In any of the securities specified in section 20 of the Indian Trusts Act, 1882.

c) In the shares, securities, bonds or debentures of any other society with limited liability.

d) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.

e) In any other moneys permitted by the Central or State Government.

In the principal provision relating to the investments of funds of a co-operative society, the Central as well as State Acts does not mention anything about the investment of reserve fund outside the business specifically.

Appropriation of profits

According to section 33 of the Central Act, a prescribed percentage of the profits should be transferred to Reserve Fund, before distribution as dividends or bonus to members.

Contributions to Charitable Purposes

According to section 34, a registered society may, with the sanction of the Registrar, contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose as defined in section 2 of the Charitable Endowments Act, 1890.

Investment of Reserve Fund outside the business or utilisation as working capital

Some of the State Acts provide that a society may use the Reserve Fund:

a) in the business of a society, as working capital (subject to the rules made in this behalf).

b) may invest as per provisions of the Act.

c) may be used for some public purposes likely to promote the object of the society. The auditor should ensure strict compliance with the State Act and Rules in this regard.

Contribution to Education Fund

a) Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State Federal Society, at the appropriate rate as per the class of the society.

b) Contribution to Education Fund is a charge on profits and not an appropriation.

c) Transfers to other reserves, dividends to members etc. are the other appropriations. Appropriations of profits must be approved by the General Body of the society, which is the supreme authority in the co-operative management.

d) Further, it may be noted that necessary accounting entries for the appropriation of profits must be passed after the date of approval by the General Body. Here there is a departure from corporate accounting practice, where entries are passed for proposed appropriations, subject to approval of Annual General Meeting.

f) According to certain State Acts, transfers to Dividend Equalization Reserve and Share Capital Redemption Fund are stated as charges against profits. According to the generally accepted principles of accountancy these items are not charges, but appropriation of profits.

g) The auditor should point out such spots where statutory provisions of any law are in contradiction with the generally accepted accounting principles.

SPECIAL FEATURES OF CO-OPERATIVE SOCIETY

The general processes of auditing involved in audit work such as checking of posting, ascertainment of arithmetical accuracy, vouching, verification of assets and liabilities and final scrutiny of Balance Sheet are well known to the students, and the same are to be applied in co-operative audit as well. The special features of co-operative audit, to be borne in mind in general while conducting the audit are as follows:

Examination of overdue debts

a) Overdue debts for a period from **6 months to 5 years** and **more than 5 years** will have to be classified and shall have to be reported by an auditor.

b) Overdue debts have **far reaching consequences** on the working of a credit society. It affects its working capital position.

c) A **further analysis** of these overdue debts from the **viewpoint of chances of recovery will have to be made**, and they will have to be classified as good or bad.

d) The auditor will have to **ascertain whether proper provisions for doubtful debts are made** and whether the same is satisfactory.

Overdue Interest

a) Overdue interest should be **excluded** from interest outstanding and accrued due while calculating profit.

b) Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue.

c) In practice **an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.**

Certification of Bad Debts

a) A peculiar **feature** regarding the writing off of the bad debts as per Maharashtra State Co-operative Rules, 1961, is very interesting to note. As per the said rules, **bad debts can be written of only when they are certified as bad by the auditor**.

b) Bad debts and irrecoverable losses before being written o against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires.

c) Where no such requirement exists, **the managing committee** of the society must authorise the write-off.

Valuation of Assets and Liabilities

a) Regarding valuation of assets there are no specific provisions or instructions under the Act and Rules and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted.

b) The auditor will have to **ascertain existence, ownership and valuation of assets**.

c) Fixed assets should be **valued at cost less adequate provision for depreciation**.

d) The incidental expenses incurred in the acquisition and the installation expenses of assets should be properly capitalised. If the difference in the original cost of acquisition and the present market price is of far reaching significance, a note regarding the present market value may be appended; so as to have a proper disclosure in the light of present inflatory conditions.

e) The current assets should be **valued at cost or market price, whichever is lower**.

f) Regarding the liabilities, the auditor should see that all the known liabilities are brought into the account, and **the contingent liabilities are stated by way of a note**.

Observations of the Provisions of the Act and Rules

a) An auditor of a co-operative society is required to **point out** the infringement **(Non-Compliance)** with the provisions of Co-operative Societies Act and Rules and bye-laws.

b) The **financial implications** of such infringements **should be properly assessed** by the auditor and they should be reported.

c) Some of the State Acts contain **restrictions on payment of dividends**, which **should be noted by the auditor**.

Verification of Members' Register and examination of their pass books

Examination of **entries in members pass books regarding the loan given and its repayments, apply SA 505** for obtaining the **confirmation of loan balances**.

Special report to the Registrar

During the course of audit, if the auditor notices that there are some **serious irregularities** in the working of the society, he may **report these special matters to the Registrar, drawing his specific attention to the points**. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance a special report may become necessary:

a) **Personal profiteering** by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.

b) **Detection of fraud** relating to expenses, purchases, property and stores of the society.
c) Specific examples of **mis-management** like decisions of management against co- operative principles.
d) In the case of urban co-operative banks, **disproportionate advances to vested interest** groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of **reckless advancing**, where the management is negligent about taking adequate security and proper safeguards for judging the **credit worthiness** of the party.

Audit classification of society

a) After a judgement of an overall performance of the society, the **auditor has to award a class to the society**.
b) This judgement is to be based on the criteria specified by the Registrar.
c) It may be noted here that **if the management of the society is not satisfied about the award of audit class**, it can make an **appeal to the Registrar**, and the **Registrar may direct to review** the audit classification.
d) The auditor should be very careful, while making a decision about the class of society.

Discussion of draft audit report with managing committee

a) On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report.
b) The audit report should **never be finalized without discussion with the managing committee**. Minor irregularities may be got settled and rectified.

Adherence to Co-operative Principles

a) The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working.
b) The assessment is not necessarily in terms of profits, but in terms of extending of benefits to members who have formed the society.
c) Considered from the viewpoint of social benefits it may be looked into that how far the sales could be a ected at lower prices.
d) For the achievement of these activities, cost accounting methods, store control methods, techniques of standard costing, budgetary control etc. should be adopted.
e) However, these modern techniques are mostly not in application and as such in practice a wide gap is found in the goals to be achieved and the actual achievements.
f) While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds.
g) Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.

AUDIT, INQUIRY AND INSPECTION OF MULTI-STATE CO- OPERATIVE SOCIETIES

Introduction

1) The Multi-State Co-operative Societies Act, 2002, which came into force in August, 2002 applies to co-operative societies **whose objects are not confined to one State.**
2) The Act contains detailed provisions regarding registration, membership and management of such societies.
3) **The funds of a Multi-State co-operative society cannot be utilised for any political purpose.**
4) **The Act contains detailed provisions regarding the investment of funds and restrictions on loans, borrowings, etc.**

BOOKS OF ACCOUNTS

As per Multi-State Co-operative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to:

a) **All sum of money received and expended** and the matters in respect of which the receipt and expenditure took place.
b) **All sales and purchases of goods.**
c) **The assets and liabilities of the society.**
d) In the case of Multi State Co-operative Society engaged in production, processing and manufacturing **particulars relating to utilization of materials or labor** or other term of cost as may be specified in the bye laws of such a society.

QUALIFICATION OF AUDITORS

Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a **Chartered Accountant** within the meaning of the Chartered Accountants Act, 1949 **can only be appointed as auditor of Multi-State co-operative society.**

However, the following persons are **not eligible** for appointment as auditors of a Multi- State co-operative society-

a) **A body corporate.**
b) **An officer or employee of the Multi-State co-operative society.**
c) **A person who is a member or who is in the employment, of an o cer or employee of the Multi-State co-operative society.**
d) A person who is **indebted to the Multi-State co-operative society** or who has **given any guarantee** or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society **for an amount exceeding one thousand rupees.**

If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his o ce as such.

APPOINTMENT OF AUDITORS

a) **Section 70** of the Multi-State Co-operative Societies Act, 2002 provides that the **first auditor** or auditors of a Multi-State co-operative society shall be **appointed by the board within one month of the date of registration** of such society and the **auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting**.

b) **If the board fails** to exercise its powers under this sub-section, **the Multi-State co-operative society in the general meeting may appoint the first auditor or auditors**.

c) **The subsequent auditor** or auditors are **appointed** by Multi-State co-operative society, **at each annual general meeting**.

d) **The auditor or auditors so appointed shall hold office from the conclusion of that meeting until the conclusion of the next annual general meeting**.

POWER AND DUTIES OF AUDITORS

1) **Section 73** of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors.

2) According to this, every auditor of a Multi-State co-operative society shall have a **right of access at all times to the books accounts and vouchers** of the Multi-State co-operative society, **whether kept at the head office** of the Multi-State co-operative society **or elsewhere**, and shall be **entitled to require from the officers or other employees** of the Multi-State co-operative society such **information and explanation as the auditor may think necessary** for the performance of his duties as an auditor.

3) As per **Section 73(2)**, the auditor shall make following inquiries:

   a) Whether **loans and advances made** by the Multi-State co-operative society on the basis of security have been **properly secured** and whether the **terms** on which they have been made are **not prejudicial** to the interests of the Multi-State co- operative society or its members,

   b) Whether **transactions** of the Multi-State co-operative society which are **represented merely by book entries** are not prejudicial to the interests of the Multi-State co-operative society.

   c) **Whether personal expenses have been charged to revenue account**, and

   d) Where it is Stated in the books and papers of the Multi-State co-operative society that any **shares have been allotted for cash**, whether **cash has actually, been received in respect of such allotment**, and **if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading**.

CONTENT OF AUDITOR'S REPORT

As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the **auditor shall make a report to the members** of the Multi-State co-operative society on the **accounts examined by him and on every balance-sheet and profit and loss account and on every other document** required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, **and give a true and fair view:**

a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and

b) In the case of the profit and loss account, of the profit or loss for its financial year. **The auditor's report shall also state:**

   (i) Whether he has **obtained all the information and explanation** which to the best of his knowledge and belief were necessary for the purpose of his audit.

   (ii) Whether, in his opinion, **proper books of account have been kept** by the Multi- State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.

   (iii) Whether the **report on the accounts of any branch office** audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.

   (iv) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt **with by the report are in agreement with the books of account and return**.

c) Where any of the matters referred to in **sub-section (3) or (4) is answered in the negative** or with a **qualification, the auditor's report shall state the reason** for the answer.

POWER OF CENTRAL GOVERNMENT TO DIRECT SPECIAL AUDIT IN CERTAIN CASES (SECTION 77)

Under **section 77 of the Multi-State Co-operative Societies Act,** 2002, where the Central Government is of the opinion:

a) That the **Affairs** of any Multi-State co-operative society are not being managed in accordance with **self-help and mutual deed and co-operative principles** or **prudent commercial practices** or **with sound business principles**; or

b) That any Multi-State co-operative society is being managed in a manner likely to cause **serious injury or damage** to **the interests of the trade industry or business** to which it pertains; or

c) That the **financial position** of any Multi-State co-operative society is such as to **endanger its solvency**.

Important Aspects

1) Central Government's Order:

The Central Government may at any time by order direct that a special audit of the Multi-State co-operative society's accounts for such period or periods as may be specified in the order shall be conducted.

2) Appointment of the Auditor:

It may appoint either **a chartered accountant** or the **Multi-State co-operative society's auditor himself** to conduct the special audit.

3) Shareholding Restriction:

However, Central Government shall order for special audit only if that Government or the State Government either by itself or **both hold fifty-one percent or more of the paid-up share capital** in such Multi-State co-operative society.

4) Special Auditor's Powers, Duties & Report:

a) The special auditor shall have the same powers and duties in relation to the special audit as an auditor of a Multi- State co-operative society has under section 73.

b) However, the special auditor shall instead of making his report to the members of the Multi-State co-operative society **make the report to the Central Government**.

c) The report of the special auditor shall, include all the matters required to be included in the auditor's report under section 73 and any other matter as directed by the Central Government.

5) Action by the Central Government:

a) On receipts of the report of the special auditor the Central Government may take such action on the report as it considers necessary in accordance with the provision of the Act or any law for the time being in force.

b) However, **if the Central Government does not take any action on the report within four months** from the date of its receipt, that Government shall send to the Multi- State Co-operative society either a copy of, or relevant extract from, the report with its comments thereon and require the Multi-State Co-operative society either to circulate that copy or those extracts to the members or to have such copy or extracts read before the Multi-State Co-operative society at its next general meeting.

6) Expenses pertaining to the Special Audit:

The **expenses** of, and incidental to, any special audit under this section (including the remuneration of the special auditor) shall be **determined by the Central Government** which determination shall be final and **paid by the Multi-State Co-operative society** and in default of such payment, shall be recoverable from the Multi-State Co-operative society as an arrear of land revenue.

INQUIRY BY CENTRAL REGISTRAR UNDER SECTION 78

When

The Central Registrar may, **on a request** from

a) a **federal co-operative** to which a Multi- State Co-operative society is a liated or

b) **a creditor or not less than one-third of the members** of the board or

c) **not less than one-fifth** of the **total number of members** of a Multi-state co-operative society,

How

Hold an inquiry or direct some person authorized by him by order **in writing** in his behalf to hold an inquiry into the constitutions, working and financial condition of a Multi-State Co-operative society.

Opportunity of being Heard

However, before holding such inquiry **fifteen days'** notice must be given to the Multi-State co-operative society.

Powers given

The Central Registrar or the person authorized by him shall have the following powers, namely:

a) He shall at all **reasonable times have free access to the books, accounts, documents, securities, cash and other properties** belonging to or in the custody of the Multi-State co-operative society and may summon any person in possession or responsible for the custody of any such books, accounts, documents securities, cash or other properties to produce the same at any place specified by him.

b) He may, notwithstanding any bye-law specifying the period of **notice for a general meeting of the Multi-State co-operative society,** require the officers of the society to call a general meeting of the society by giving notice of **not less than seven days** at such time and place at the headquarters of the society to consider such matters as may be directed to him, and where the o cers of the society refuse or fail to call such a meeting, he shall have power to call it himself.

c) he may **summon any person who is reasonably believed by him to have any knowledge** of the affairs of the Multi-State co-operative society to appear before him at any place at the headquarters of the society or any branch thereof and may examine such person on oath.

Follow up

The Central Registrar shall, **within a period of three months** of the date of receipt of the report, communicate the report of inquiry to the Multi-State co-operative society, the financial institutions, if any, to which the society is affiliated, and to the person or authority, if any at whose instance the inquiry is needed.

INSPECTION OF MULTISTATE CO-OPERATIVE SOCIETIES UNDER SECTION 79

When

The Central Registrar may, on **a request** from

a) **Federal co-operative** to which a Multi- State Co-operative society is a liated or a creditor or
b) **Not less than one-third** of the members of the board or
c) **Not less than one-fifth** of the **total number of members** of a Multi-State co-operative society

How

By general or special order **in writing** in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi- State co-operative society.

Opportunity of Being heard

No inspection shall be made unless a notice of **not less than fifteen days** has been given to the multi-state co-operative society.

Powers available

The Central Registrar or the person authorized by him shall have the following powers:

a) He shall **at all times have access** to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, **take them into custody** and shall have **power to verify the cash balance of the society** and **subject to the general or special order** of the central registrar to **call a meeting of the society where such general meeting is, in his opinion necessary.**
b) **Every officer or member** of a Multi-State Co-operative society **shall furnish such information with regard to the working of the society** as the central registrar or the person making such inspection may require.

Inspection Report

A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of **three months from the date of completion of such inspection.**

AUDIT OF TRUSTS AND SOCIETIES

INTRODUCTION

There are three basic legal forms of charitable entities under Indian law: trusts, societies, and section 8 companies.

The legal framework governing the charitable institution will depend on the form of business organization the charitable institution takes.

a) If the charitable institution is formed as **a Public Trust**, it will be **governed by the Public Trust Act** applicable in the relevant State. However, if no Public Trust Act exists in that state, then the applicable legislation will be the Indian Trusts Act, 1882.

b) If the charitable institution is formed as **a Society**, it will be **governed by the Societies Registration Act, 1860**.

c) The charitable institution can also be formed as a **non-profit company under section 8** of the Companies Act, 2013.

d) Apart from the above legislations, the **Income Tax Act 1961** will be applicable to charitable institutions.

e) And in the case of **foreign contributions** to these charitable institutions, the **Foreign Contribution (Regulation) Act, 2010 will be applicable**.

BOOKS OF ACCOUNT

Charitable and religious trusts should **maintain regular books of account**. This will **enable management to demonstrate** due discharge of responsibilities they assume.

The Auditor is required **to report** whether the Trust has maintained proper books of accounts, including the following, namely:

(i) cash book;

(ii) ledger;

(iii) journal;

(iv) copies of bills, whether machine numbered or otherwise serially numbered, wherever such bills are issued by the trust, and copies or counterfoils of machine numbered or otherwise serially numbered receipts issued by the trust;

(v) original bills wherever issued to the person and receipts in respect of payments made by the person;

(vi) any other book that may be required to be maintained in order to give a true and fair view of the state of the affairs of the person and explain the transactions

FINANCIAL STATEMENTS

1) Every year the **trust has to prepare financial statements** like the Balance sheet and Income and expenditure statements based on its books of accounts.
2) **The format for preparation and presentation** of financial statements is **prescribed under respective state laws**.
3) Charitable Organisations are **governed** by different laws as well as different forms of organisations also necessitate different accounting aspects to be complied.

Auditor's responsibility

a) The auditor should **obtain the list of the books and records** maintained by the Trust. The list should be matched with the above requirement for maintaining mandatory books and records as may be applicable in each case.
b) The auditor should then **verify the records** for the purpose of its audit. He has to **comply with the Accounting Standards (AS) and Standards on Auditing (SA) prescribed** and made mandatory by the Institute of Chartered Accountants of India.
c) In giving his report the **auditor** will have to **use his professional skill and expertise** and **apply** such **audit tests** as the circumstances of the case may require, considering the contents of the audit report.
d) He will have **to conduct the audit** by applying the **generally accepted auditing procedures**, which are applicable for any other audit.
e) He can **apply the test checks** depending on the **evaluation of internal control procedures** followed by the assessee.
f) The auditor will also have **to keep in mind the concept of materiality** depending upon the circumstances of each case.
g) He should **keep detailed notes** about the evidence on which he has relied upon while conducting the audit and also maintain all his working papers.

Such working papers should include his notes on the following, amongst other matters:

a) **Work done** while conducting the audit and by whom;
b) **Explanation and information given** to him during the course of the audit and by whom;
c) **Decision** on the various points taken;
d) **The judicial pronouncements** relied upon by him while drafting the audit report; and
e) **Certificates issued** by the client / management letters.

It is important that the audit working papers prepared and/or obtained by the auditor provide evidence that:

a) The **opinion expressed** by the auditor is based on the examination made by him;
b) In **arriving at his opinion**, the auditor has given **due cognizance** to the information and explanations given by the assessee and that his opinion is not arbitrary;
c) The **information and explanations** obtained were **full and complete** that is, the auditor has called for all the information and explanations which were necessary to be considered before arriving at his opinion; and
d) The auditor **did not merely rely upon the information or explanations** given by the assessee **but** that he **subjected such information and explanations** to reasonable tests **to verify** their accuracy and completeness

TRUSTS

The auditor has to ascertain :

1) Whether accounts are **maintained regularly and in accordance** with the provisions of the applicable Act and the rules;
2) Whether **receipts and disbursements are properly and correctly shown** in the accounts and money received in the form of donations is being applied as per the objects of the trust and as per the specific direction by the donor, if any.
3) Whether the **cash balance and vouchers** in the custody of the manager or trustee on the date of audit **were in agreement with the accounts;**
4) Whether all **books, deeds, accounts, vouchers or other documents or records** required by the auditor were **produced before him;**
5) Whether a **register of movable and immovable properties is maintained**, the changes therein are communicated from time to time to the regional office, and the defects and inaccuracies mentioned in the previous audit report have been duly complied with and rectified.
6) Whether the **manager or trustee or any other person** required by the auditor to appear before him **did so and furnished** the necessary information required by him;
7) Whether any **property or funds** of the Trust were **applied for** any **object or purpose other than** the **object or purpose of the Trust;**
8) The amounts of **outstanding for more than one year** and the **amounts written off**, if any;
9) Whether **any money** of the public trust has been **invested contrary to the provisions** of applicable Act which have come to the notice of the Auditor
10) All cases of **irregular, illegal or improper expenditure, or failure or omission to recover monies or other property** belonging to the public trust or of loss or waste of money or other property thereof, and whether such expenditure, failure, omission, loss or waste was **caused in consequence of breach of trust or misapplication or any other misconduct** on the part of the trustees or any other person while in the management of the trust
11) Whether the **maximum and minimum** number of the trustees is maintained;
12) Whether the meeting are **held regularly** as provided in such instrument

13) Whether the **minute books of the proceedings** of the meeting is **maintained**
14) Whether any of the **trustees** has **any interest** in the investment of the trust
15) Whether any of the **trustees** is a **debtor or creditor** of the trust.
16) Whether **anonymous donations** received are **properly accounted** for and donations in cash are not received by the Trust over and above the prescribed limit of accepting cash donations.
17) Whether the **irregularities pointed out** by the auditors in the accounts of the previous year have been **duly complied** with by the trustees during the period of audit
18) **Any special matter** which the auditor may think fit or necessary to bring to the notice of the Deputy or Assistant Charity Commissioner

SOCIETIES

The auditor's considerations:

1) **The auditor** should **ascertain** governing legislation of society i.e. Societies Registration act, 1860 or any applicable state law under which it has been registered.
2) **Object** of society **needs to be ascertained** from its **memorandum of association/bye laws.** Its activities may include charitable, social, cultural or educational activities.
3) **Ascertain** whether society has **obtained registration** under Foreign Contribution (Regulation) Act, 2010 in case foreign contributions are received.
4) **Ascertain** whether it is also **registered under relevant provisions of Income Tax Act** which may make it eligible for tax exemption on its income.
5) **Obtain an understanding** of internal control to design audit procedures with special reference to donations and various expenditures incurred in relation to achievements of objects of society.
6) **Evaluate appropriateness** of accounting policies with special reference to donations and grants. Also evaluate accounting policies in relation to specific grants.
7) In case some expenses incurred by society are reimbursed by donors, ascertain how these are recognized in financial statements.
8) **Ascertain**, if any **inquiry** has been **held by Registrar** under applicable law in the working or financial condition of society and its implications for auditor's opinion.
9) **Ascertain** all cases of **irregular, illegal or improper expenditure or failure or omission** to recover monies or other property belonging to society or of loss or waste of money or other property thereof.
10) **Ascertain** whether such **expenditure or waste** was caused in **consequence of breach of trust or misapplication or any other misconduct** on the part of governing body.

BANK AUDIT

INTRODUCTION

1) Banking sector is the backbone of any economy as it is essential for sustainable socio-economic growth and financial stability in the economy.
2) The banking sector is also crucial as it deals with mammoth amounts of public monies and is highly sensitive to reputational risk.
3) Like all economic activities, the banking sector is also exposed to various risks in its operations.
4) It is of utmost importance to ensure that banking sector stays healthy, safe and sound.
5) **For safe and sound banking sector, one of the most important factors is reliable financial information supported by quality bank audits.**

TYPES OF BANKS

There are different types of banking institutions prevailing in India which are as follows:

a) **Commercial Banks**
b) **Cooperative Banks**
c) **Development Banks (more commonly known as 'Term-Lending Institutions')**
d) **Regional Rural Banks**
e) **Payment Banks**
f) **Small Finance Banks**

Commercial banks

They are the most wide-spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Two of its main functions are:

a) accepting deposits and
b) granting advances.

Regional Rural Banks

They are known as RRBs are the banks

Examples: Punjab Gramin Bank, Tripura Gramin Bank, Allahabad UP Gramin Bank, Andhra Pradesh Grameen Vikas Bank, etc.

Co-operative Banks

They function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors.
Examples: The Gujarat State Co-operative Bank Ltd., Chhatisgarh Rajya Sahakari Bank Maryadit.

Payments Banks

They are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards. However, customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards, Internet-banking & Mobile banking.

Examples: Airtel Payments Bank, India Post Payments Bank, Paytm Payments Bank, etc.

Development Banks

They had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country.

Examples: Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI), etc.

Small Finance Banks

They have been set up by RBI to make available basic financial and banking facilities to the unserved and unorganized sectors like small marginal farmers, small & micro business units, etc.

Examples: Equitas Small Finance Bank, AU Small Finance Bank, etc.

RESERVE BANK OF INDIA: REGULATING BODY

1) The functioning of banking industry in India is regulated by the **Reserve Bank of India (RBI) which acts as the Central Bank of our country.**
2) **RBI is responsible for:**
   a) **development and supervision** of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions)
   b) for determining, in conjunction with the Central Government, **the monetary** and **credit policies keeping** in with the need of the hour.
   c) **regulating** the activities of commercial and other banks
3) **Important functions of RBI are:**
   a) **issuance of currency;**
   b) **regulation of currency issue;**
   c) **acting as banker to the central and state governments; and**
   d) **acting as banker to commercial and other types of banks including term-lending institutions. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks.**
4) **No bank can commence the business of banking or open new branches without obtaining license from RBI.** The RBI also has the **power to inspect any bank.**

BANKING OPERATIONS - CONDUCTED ONLY AT BRANCHES

1) Banking operations are conducted only at the branches, while other **offices act as controlling authorities** or **administrative offices that lay down policies, systems and internal control procedures** for conduct of business, **in compliance with the statutory / regulatory impositions** and in compliance of **accepted accounting principles** and **practices that cover all transactions and economic events**.

2) These controlling / administrative o ces also stipulate the **delegation of powers and fix responsibilities and accountability** and these are involved generally in **effective supervision, monitoring and control** over the business activities and operations, including seeking faithful compliance of the bank's laid down policies/ procedures / controls and deal with deviations therefrom.

3) Regulatory Framework
   a) Banking Regulation Act, 1949.
   b) State Bank of India Act, 1955.
   c) Companies Act, 2013.
   d) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.
   e) Regional Rural Banks Act, 1976.
   f) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.
   g) Information Technology Act, 2000.
   h) Prevention of Money Laundering Act, 2002.
   i) Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.
   j) Credit Information Companies Regulation Act, 2005.
   k) Payment and Settlement Systems Act, 2007.

4) Besides, the above enactments, the provisions of the Reserve Bank of India Act, 1934, (RBI Act) also affect the functioning of banks. The RBI Act gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

5) **Peculiarities involved:**
   a) **Huge volumes and complexity of transactions,**
   b) **Wide geographical spread of banks' network,**
   c) **Large range of products and services o ered,**
   d) **Extensive use of technology,**
   e) **Strict vigilance by the banking regulator etc.**

TYPES OF BANK AUDIT REPORTS TO BE ISSUED (GENERALLY)

Presently, the **Statutory Central Auditors (SCAs)** have to furnish the following reports in addition to their main audit report:

1) Report on **adequacy and operating effectiveness of Internal Controls over Financial Reporting** in case of banks which are registered as companies under the Companies Act in terms of **Section 143(3)(i) of the Companies Act, 2013** which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
2) **Long Form Audit Report.**
3) Report on **compliance with SLR requirements.**
4) Report on whether the **treasury operations of the bank** have been conducted in accordance with the instructions issued by the RBI from time to time.
5) Report on whether the **income recognition, asset classification and provisioning** have been made **as per the guidelines issued by the RBI** from time to time.
6) Report on whether **any serious irregularity was noticed** in the working of the bank which requires immediate attention.
7) Report on status of the compliance by the bank with regard to the **implementation of recommendations of the Ghosh Committee relating to frauds and malpractices** and of the **recommendations of Jilani Committee on internal control and inspection/credit system.**
8) Report on instances of **adverse credit-deposit ratio in the rural areas.**

UNDERSTANDING OF ACCOUNTING SYSTEMS IN BANKS

1) The transactions in banks have become **voluminous** and it needs to be ensured that in the system of **recording, transmission and storage of information/ data**, integrity thereof is **optimally maintained and control systems** ensure that the same is **free of risks of errors, omissions, irregularities and frauds.**
2) Considering the challenges of technology, bank managements continuously **endeavor to** make the **internal control systems robust, safe and secure as well as convenient and expeditious for the customers.**
3) In the Computerized environment, it is imperative that the **auditor is familiar with, and is satisfied that, all the norms / parameters as per the latest applicable RBI guidelines are incorporated and built into the system** that generates information/data having a bearing on the classification / provisions and income recognition.
4) The auditor should **not go by the assumption that the system generated information is correct** and **can be relied upon without evidence** that demonstrates that the system driven information is based on validation of the required parameters.
5) **He should use Professional Skepticism and Prudence wherever** he feels that something manually needs to be performed to check the authenticity and consistency of the information obtained from the systems and document the results of such activities performed.

BANK AUDIT APPROACH

Drawing an Audit Plan

An audit plan should be drawn up based on:

a) the nature and level of operations,
b) nature of adverse features,
c) level of compliance based on previous reports and
d) audit risks based on inadequacy in or breach of internal controls and the familiarization exercise carried out.

Control Environment at the Bank

A bank should have appropriate controls to mitigate its risks, including

a) effective segregation of duties (particularly, between front and back offces),
b) accurate measurement and reporting of positions,
c) verification and approval of transactions,
d) reconciliation of positions and results,
e) setting up limits,
f) reporting and approval of exceptions,
g) physical security and contingency planning.

The following are certain common questions / steps, which have to be kept in mind while undertaking / performing control activities:

Nature of Questions	Questions to be considered / answered
Who	a) Who performs the control? b) Does the above person have requisite knowledge and authority to perform the control?
What	a) What evidence is available to demonstrate /prove that the control is performed?
When	a) When and with what frequency is the control performed? b) Is the frequency enough to prevent, detect and correct Risk of Material Misstatements?

Where	a) Where is the evidence of performance of the control retained? b) For how long is the evidence retained? c) Is the evidence accessible for / available for audit?
Why	a) Why is the control being performed? b) What type of errors are prevented or detected through the performance of the control?
How	a) How is the control performed? b) What are the control activities? c) Can these activities be bypassed? d) Can the bypass, if any, be detected? e) How are exceptions / deviations resolved on identification? f) What is the time frame for resolving the exceptions / deviations?

Engagement Team Discussions

a) All **personnel performing an engagement**, including **any experts** contracted by the firm in connection with that engagement are known to be the **"Engagement Team"**.

b) The engagement team should hold discussions to **gain better understanding of the bank and its environment, including internal control**, and also to **assess the potential for material misstatements** of the financial statements.

c) All these discussions should be **appropriately documented** for future reference.

d) The discussion between the members of the engagement team and the audit engagement partner should be **done on the susceptibility of the bank's financial statements to material misstatements**. These discussions are **ordinarily done at the planning stage of an audit**.

The engagement team discussion ordinarily includes a discussion of the following matters:

a) Errors that may be more likely to occur;

b) Errors which have been identified in prior years;

c) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;

d) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;

e) Need to maintain professional skepticism throughout the audit engagement;

f) Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

Advantages of such a discussion

a) Specific emphasis should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.

b) It further enables the audit engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified.

c) Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

INCOME RECOGNITION POLICY

a) The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations.

b) Income from Non-Performing Assets (NPA) is not recognised on accrual basis but is booked as income only when it is actually received.

FORMS AND CONTENT OF FINANCIAL STATEMENTS

1) Sub-sections (1) and (2) of section 29 of the Act deal with the form and content of financial statements of a banking company and their authentication.

2) These sub- sections are also applicable to nationalized banks, State Bank of India, and Regional Rural Banks.

3) Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit.

4) Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

5) Every banking company needs to comply with the disclosure requirements under the various Accounting Standards, as specified under section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or the Accounting Standards issued by the ICAI.

AUDIT OF ACCOUNTS

Sub-section (1) of section 30 of the Act requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

ELIGIBILITY, QUALIFICATION AND DISQUALIFICATION OF AN AUDITOR

Applicable as to a Company Auditor

APPOINTMENT OF AUDITOR

As per the provisions of the relevant enactments:

a) The **auditor of a banking company** is to be **appointed at the annual general meeting of the shareholders**,

b) The **auditor of a nationalized bank** is to be appointed by the bank concerned acting through its **Board of Directors**.

c) The **auditors of regional rural banks** are to be **appointed by the bank** concerned with the **approval of the Central Government**.

Note :

In either case, approval of the Reserve Bank of India is required before the appointment is made

REMUNERATION OF AUDITOR

1) The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of **section 142 of the Companies Act, 2013** (i.e., by the company in general meeting or in such manner as the company in general meeting may determine).

2) The **remuneration of auditors of nationalized banks and State Bank of India** is to be **fixed by the Reserve Bank of India** in consultation with the Central Government.

POWER OF AUDITOR

The auditor of a banking company, nationalized bank, State Bank of India, regional rural bank has the **same powers as those of a company auditor** in the matter of access to the books, accounts, documents and vouchers.

AUDITOR'S REPORT

In the case of a nationalized bank, the auditor is required to make a report to the Central Government in which he has to state the following:

a) whether, in his opinion, **the financial statements present a true and fair view** of the affairs of the bank and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;

b) whether or not the transactions of the bank, **which have come to his notice, have been made within the powers of that bank**;

c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit; and

d) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalized bank.

FORMAT OF REPORT

1) The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of Standards on Auditing discussed in Chapter 8 on Audit Report.
2) The auditor should ensure that not only information relating to number of unaudited branches is given but quantification of advances, deposits, interest income and interest expense for such unaudited branches has also been disclosed in the audit report.
3) Such disclosure in the audit report is not only in accordance with the best international trends but also provides useful information to users of financial statements.
4) It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in his report the matters covered by Section 143 of the Companies Act, 2013.
5) However, it is pertinent to mention that the reporting requirements relating to the Companies (Auditor's Report) Order, 2020 is not applicable to a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949.

LONG FORM AUDIT REPORT

1) Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a Long Form Audit Report (LFAR).
2) The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.
3) The Statutory Central Auditors are required to submit the LFAR to the banks latest by 30th June every year.
4) To ensure timely submission of LFAR, proper planning for completion of the LFAR is required.
5) While the format of LFAR does not require an executive summary to be given, members may consider providing the same to bring out the key observations from the whole document.

REPORTING TO RBI

1) The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under:

   "If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".

   As per the above requirement, the member shall be required to report the kind of matters stated in the circular to RBI.

2) Auditor should also consider the provisions of **SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"**. The said Standard explains that the duty of confidentiality is over-ridden by statute, law or by courts.

3) **SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements "states**

   a) that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

   b) It must be noted that auditor is **not expected to look into each and every transaction but to evaluate the system as a whole**.

   c) Therefore, if the auditor while performing his normal duties comes across any instance, he **should report the matter to the RBI** in addition to **Chairman/Managing Director/Chief Executive of the concerned bank.**

CONDUCTING AN AUDIT

The audit of banks or of their branches involves the following stages -

Initial consideration by the statutory auditor:

1) **Declaration of Indebtedness:**

   The RBI has advised that the banks, before appointing their statutory central/branch auditors, should obtain a declaration of indebtedness. Indebtedness refers to the situation of owing money to the bank in any case, whatsoever.

2) **Internal Assignments in Banks by Statutory Auditors:**

   The RBI decided that the audit firms should not undertake statutory audit assignment while they are **associated with internal assignments** in the bank during the same year like

Concurrent audits (Internal Audit of Banks conducted monthly during the year).

3) **Planning:**

Standard on Auditing **(SA) 300, "Planning an Audit of Financial Statements"** requires that the auditor shall undertake the following activities prior to starting an initial audit:

a) Performing procedures required by **SA 220, "Quality Control for Audit Work"** regarding the acceptance of the client relationship and the specific audit engagement; and

b) Establish understanding of terms of engagement as per **SA 210, "Agreeing the Terms of Audit Engagements".**

4) **Communication with Previous Auditor:**

As per **Clause (8) of the Part I of the First Schedule** to the Chartered Accountants Act, 1949, a chartered accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him in writing. He should get a **No Objection Certificate (NOC) from the previous auditor** through this communication as to know whether **he has any objections** to such an appointment made, for any valid reasons

5) **Terms of Audit Engagements:**

SA 210, "Terms of Audit Engagements" requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork. It is imperative that the terms of the engagement are documented, in order to prevent any confusion as to the terms that have been agreed in relation to the audit and the respective responsibilities of the management and the auditor, at the beginning of an audit assignment.

6) **Initial Engagements:**

The auditor needs to perform the audit procedures as mentioned in **SA 510 "Initial Audit Engagements-Opening Balances"** and if after performing that procedures, the auditor concludes that the opening balances contain misstatements which materially a ect the financial statements for the current period and the e ect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

7) **Assessment of Engagement Risk:**

The assessment of engagement risk is a **critical part** of the audit process and should be done prior to the acceptance of an audit engagement since it a ects the decision of accepting the engagement and also in planning decisions if the audit is accepted.

8) **Establish the Engagement Team:**

he assignment of qualified and experienced professionals is an **important component of managing engagement risk**. The size and composition of the engagement team would depend on the size, nature, and complexity of the bank's operations.

9) <u>Understanding the Bank and its Environment:</u>

SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" lays down that the auditor should obtain an understanding of the entity and its environment, including its internal control, su cient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and su cient to design and perform further audit procedures.

Identifying and Assessing the Risks of Material Misstatements

SA 315 requires the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures.

Understanding the Bank and Its Environment including Internal Control

An understanding of the bank and its environment, including its internal control, enables the auditor:

a) **To identify and assess risk;**

b) **To develop an audit plan so as to determine the operating effectiveness of the controls, and to address the specific risks.**

Understand the Bank's Accounting Process

The accounting process produces financial and operational information for management's use and it also contributes to the bank's internal control. Thus, **understanding of the accounting process** is necessary to identify and assess the risks of material misstatement whether due to fraud or not, and to design and perform further audit procedures.

Understanding the Risk Management Process

Management develops controls and uses performance indicators to aid in managing key business and financial risks. An e ective risk management system in a bank generally requires the following:

a) <u>Oversight and involvement in the control process by those charged with governance:</u> Those charged with governance (BOD/Managing Director) should approve **written risk management policies**. The **policies should be consistent with the bank's business objectives** and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.

b) <u>Identification, measurement and monitoring of risks:</u>

Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.

c) <u>Control activities:</u>

A bank should have **appropriate controls to mitigate its risks, including effective segregation of duties** (particularly, between front and back o ces), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.

d) <u>Monitoring activities:</u>

Risk management models, methodologies and assumptions used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.

e) <u>Reliable information systems:</u>

Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

Engagement Team Discussions

The engagement team should hold discussions to gain better understanding of banks and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.

Establish the Overall Audit Strategy

SA 300 "Planning an Audit of financial Statements'' states that the objective of the auditor is to plan the audit so that it will be performed in an e ective manner. For this purpose, the audit engagement partner should:

a) **Establish the overall audit strategy**, prior to the commencement of an audit; and

b) **Involve key engagement team members and other appropriate specialists** while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.

Develop the Audit Plan

SA 300 deals with the **auditor's responsibility to plan an audit of financial statements** in an effective manner.

It requires the involvement of **all the key members of the engagement team** while planning an audit.

Audit Planning Memorandum

The auditor should summarize the audit plan by preparing an audit planning memorandum in order to:

a) Describe the **expected scope and extent** of the audit procedures to be performed by the auditor.

b) **Highlight all significant issues and risks identified** during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.

c) Provide evidence that they have **planned the audit engagement appropriately** and have responded to engagement risk, pervasive risks, specific risks, and other matters a ecting the audit engagement.

Determine Audit Materiality

The auditor should **consider the relationship between the audit materiality and audit risk when conducting an audit**.

The determination of audit materiality is a matter of professional judgment and depends upon the knowledge of the bank, assessment of engagement risk, and the reporting requirements for the financial statements.

Consider Going Concern

While obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast **significant doubt on the bank's ability** to continue as a going concern.

Assess the Risk of Fraud including Money Laundering

a) As per **SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"**, the auditor's objectives is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain su cient appropriate audit evidence on those identified misstatements and to respond appropriately.

b) The **attitude of professional skepticism** should be maintained by the auditor so as to recognize the possibility of misstatements due to fraud.

c) The RBI has framed specific guidelines that deal with prevention of money laundering and **"Know Your Customer (KYC)" norms**. The RBI has from time to time issued guidelines ("Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognize and report money laundering activities.

Assess Specific Risks

The auditors should identify and assess the risks of material misstatement at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole, and potentially a ect many assertions.

Risk Associated with Outsourcing of Activities

The modern-day banks make extensive use of outsourcing as a means of both **reducing costs as well** as making use of services of an expert not available internally.

There are, however, a number of risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to e ectively manage those risks.

Response to the Assessed Risks

a) SA 330 "The Auditor's Responses to Assessed Risks" requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.

b) The auditor should design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

Stress Testing

a) Stress testing is a software testing activity that determines the robustness of software by testing beyond the limits of normal operation. Stress testing is particularly important for "mission critical" software, but is used for all types of software.

b) RBI has required that all commercial banks shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems.

BASEL III framework

a) The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis.

b) In the document titled 'Basel III: A global regulatory framework for more resilient banks and banking systems', released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital.

c) The set of agreement by the BCBS, which mainly focuses on risks to banks and the financial system are called Basel accord.

Reliance on / review of other reports

The auditor should take into account the adverse comments, if any, on advances appearing in the following-

a) Previous year's audit reports.

b) Latest internal inspection reports of bank o cials.

c) Reserve Bank's latest inspection report.

d) Concurrent / Internal audit report.

e) Report on verification of security

f) Any other internal reports specially related to particular accounts.

g) **Manager's charge-handing-over report when incumbent is changed.**

The above reports should be reviewed in detail. The Statutory Central Auditors must **review the Annual Financial Inspection** report of RBI relating to the bank and ensure that the variations in provisions, etc. reported by RBI have been properly considered by the bank management.

ADVANCES

1) In carrying out his substantive procedures, the auditor should **examine all large advances** while other advances may be examined on a sampling basis.
2) The accounts identified to be **problem accounts however need to be examined in detail** unless the amount involved is insignificant.
3) The **extent of sample checking** would also depend on the **auditor's assessment of e cacy of internal controls.**
4) What constitutes a '**large advance**' would need to be determined in the context of **volume of operations of the branch.**
5) An advance may be considered to be a large advance if the year-end balance is **in excess of Rs. 10 crore or 10% of the aggregate year- end advances** of the branch, **whichever is less.**
6) Lending constitutes a **major activity** of a bank besides the investment function. The core business of banks is accepting deposits for onward lending.
7) **Advances are amount of money or credit, given as a loan from a bank to another party with an agreement that the money will be repaid.** All Bank Loans are made at interest which is a compensation for borrowing.
8) Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are major source of its income.
9) Audit of advances is one of the **most important areas** covered by auditors in bank audit. It is necessary that auditors should have **adequate knowledge of the banking industry and the regulations governing the banks.** Auditors must be aware of the various functional areas of the bank/branches, its processes, procedures, systems and prevailing internal controls with regard to advances.

Types of Advances

a) **Funded loans** are those loans where there is an actual transfer of funds from the bank to the borrower.

   Examples of funded loans are Term loans, Cash credits, Overdrafts, Demand Loans, Bills Discounted and Purchased, Participation on Risk Sharing basis, Interest-bearing Staff Loans.

b) **Non-funded facilities** are those which **do not** involve such transfer.

   Examples of non-funded loans are Letters of credit, Bank guarantees, etc.

What do advances comprise:

Advances comprises of funded amounts by way of:

a) Term loans
b) Cash credits, Overdrafts, Demand Loans
c) Bills Discounted and Purchased
d) Participation on Risk Sharing basis
e) Interest bearing Staff Loans

Legal requirements of Disclosure in the Balance Sheet

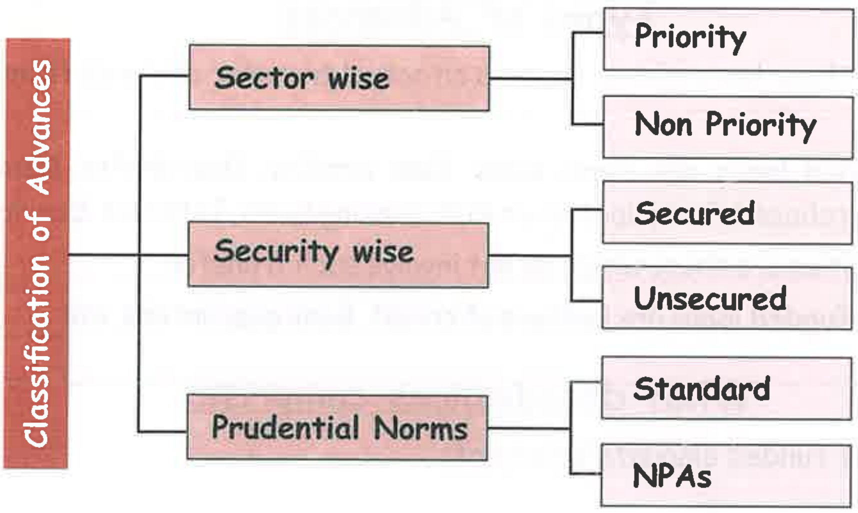
A. (i) Bills purchased and discounted
   (ii) Cash credits, Overdrafts and loans repayable on demand
   (iii) Term Loans

B. (i) Secured by tangible assets
   (ii) Covered by Bank/Government guarantees
   (iii) Unsecured

C. Advances in India
   (i) Priority sectors
   (ii) Public sector
   (iii) Banks
   (iv) Others

D. Advances outside India:
   (i) Due from Banks
   (ii) Due from Others:
      i. Bills Purchased and discounted
      ii. Syndicated loans
      iii. Others

CLASSIFICATION OF ADVANCES



SECTOR-WISE

RBI issues common guidelines for lending to Priority Sector which banks are required to follow. These guidelines cover rate of interest; service charges, receipt, sanction, rejection, disbursement Register; issue of Loan Application Acknowledgement. RBI also issues targets for banks for lending to Priority Sector.

Examples of Priority Sectors are Agriculture, MSME, Education, Housing, etc.

SECURITY-WISE

Banks ask Security or Collateral while lending to assure that the Borrower will return the money to bank in prescribed time else the Banks have legal authority to sell the collateral to recover its money.

NATURE OF SECURITY

1) **Primary security** refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.
2) **Collateral security** is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following.

a) Personal Security of Guarantor
b) Goods / Stocks / Debtors / Trade Receivables
c) Gold Ornaments and Bullion
d) Immovable Property
e) Plantations (For Agricultural Advances)
f) Third Party Guarantees
g) Banker's General Lien
h) Life Insurance Policies
i) Stock Exchange Securities and Other Instruments

MODE OF SECURITY CREATION

Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off, or lien as follows:

Mortgage

Mortgage are of several kinds but the **most important** are the Registered Mortgage and the Equitable Mortgage.

a) **A Registered Mortgage** can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.

b) **Equitable mortgage**, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

Pledge

A pledge thus **involves bailment or delivery of goods by the borrower to the lending bank** with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.

Hypothecation

a) The hypothecation is the **creation of an equitable charge** (i.e., a charge created not by an express enactment but by equity and reason), which is created in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

b) **Neither ownership nor possession are transferred to the bank**. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank.

c) The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

Assignment

a) Assignment represents **a transfer** of an **existing or future debt, right or property** belonging to a person in favour of another person.

b) **Only actionable claims** (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

c) An assignment gives the assignee **absolute right over the moneys/debts assigned to him.**

Set-off

a) Set-off is a **statutory right of a creditor** to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor.

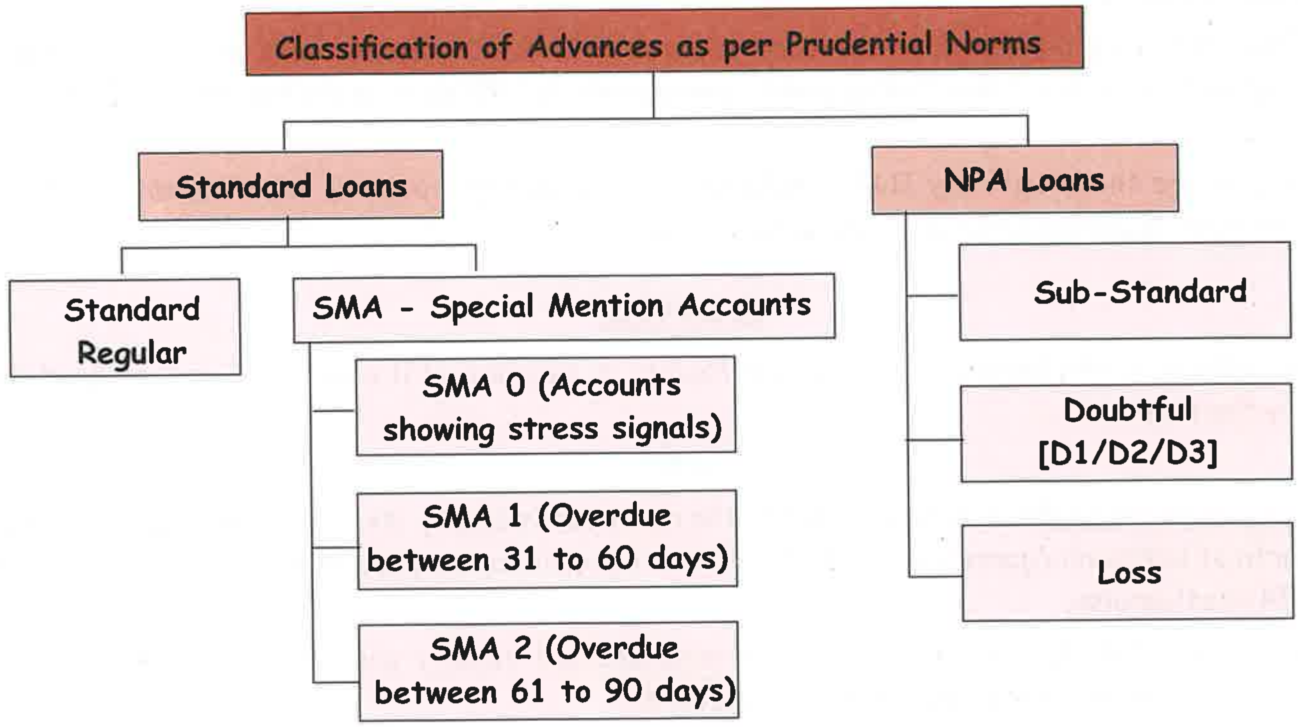
b) The right of set- off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and in the same right (i.e., the capacity of the account holder in both the accounts should be the same).

c) **For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.**

Lien

Lien is creation of a **legal charge with consent of the owner**, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

PRUDENTIAL NORMS ON INCOME RECOGNITION, ASSET CLASSIFICATION & PROVISIONING PERTAINING TO ADVANCES



Non-performing Assets

An asset becomes NPA when it ceases to generate income for the Bank. A non-performing asset (NPA) is a loan or an advance where:

a) **Interest** and/ or **installment** of principal remains **overdue for a period of more than 90 days** in respect of a term loan,

b) The account remains '**out of order**' in respect of an Overdraft/Cash Credit **(OD/ CC)**,

c) The **bill remains overdue** for a period of **more than 90 days** in the case of bills purchased and discounted,

Out of Order

An account should be treated as 'out of order' if

a) The outstanding balance remains **continuously in excess of the sanctioned limit/drawing power**.

b) In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or

c) Credits are there but not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

Example: A Ltd. has been sanctioned a Cash Credit Facility by ADB Bank Ltd. for INR 50 lacs but as per the Stock Statements furnished for the last quarter, the Bank has calculated the Drawing power to be INR 42 Lakhs.

In this case, the account would be termed as OUT OF ORDER if:

a) The outstanding balance remains continuously in excess of the INR 50 lacs/42 lacs whatever the case may be; or

b) The outstanding balance in the account is less than INR 42 lacs but there are no credits or any payments deposited into this account continuously for 90 days as on the date of Balance Sheet. or

c) Credits are there upto say INR 2 lakhs but are not enough to cover the interest debited during the same period which is around INR 5 lakhs

Overdue

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

Note:

a) Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor not be taken into account for purpose of treating an advance as NPA or otherwise.

b) Asset Classification would be borrower wise and not facility wise. All facilities including investment in securities would be termed as NPA.

For Example: Mr. Raman has availed two Loan facilities - a Car Loan as well as a Housing Loan from XYZ Bank Ltd. He is regular in depositing the Housing loan EMI but has not deposited the last 4 EMI's of the Car Loan due to paucity of funds. Hence, in this case, not only the Car loan but the Housing Loan would also be treated as an NPA, although it is going good and there are no irregularities because the NPA classification is Borrower wise (Mr. Raman) and not Facility wise (Car & Housing Loan individually).

Categories of Non-Performing Assets:	Provision required
1) **Substandard Assets:** Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
2) **Doubtful Assets:** Would be one, which has remained in the substandard category for a period of 12 months.	
Sub-categories:	(Secured + Unsecured)
Doubtful up to 1 Year (D1)	25% + 100%
Doubtful 1 to 3 Years (D2)	40% + 100%
Doubtful more than 3 Years (D3)	100% + 100%
3) **Loss Assets:** Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Accounts regularized near about the Balance Sheet Date

a) The asset classification of borrower accounts where a solitary or a **few credits are recorded before the balance sheet should be handled with care and without scope for subjectivity**.

b) Where the account indicates **inherent weakness** on the basis of the data available, the account should be deemed as an NPA.

c) The auditor should check for sample transactions immediately before the closing of the Financial Year and immediately after the closing of the Financial year to get a knowledge of the objective behind the transactions if they have any relation to each other in the Borrower accounts or if any/some transactions are being reversed during the first few days after closing which might show an arrangement to prevent the Borrower account(s) from slipping into the NPA category.

Government Guaranteed advances

a) Central Govt. Guaranteed Advances, where the **guarantee is not invoked** / repudiated would be classified as Standard Assets but regarded as NPA for Income Recognition purpose.

b) The situation would be different if the **advance is guaranteed by State Government**, where advance is to be considered NPA if it **remains overdue for more than 90 days** for both Provisioning and Income recognition purposes.

Advances under Consortium

a) Consortium advances mean advancing loans to a borrower by two or more Banks jointly by forming a **Consortium**. Joint appraisal, control and monitoring will facilitate for exchange of valuable information among the Banks. Usually, **a Bank with a higher share will lead the consortium.**

b) Consortium advances should be based on the **record of recovery of the respective individual member banks** and other aspect having a bearing on the recoverability of the advances.

c) Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

d) The banks participating in the consortium, therefore, need to arrange to get their **share of recovery transferred from the lead bank** or to **get an express consent from the lead bank** for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Note:

Drawing Power Allocation in case of Consortium Cash Credit Account:

The **Lead Bank** would be **responsible for computing the drawing power** (DP) of the borrower and allocate the same to member banks. In certain special circumstances, at the request of the Borrower, the **Lead Bank may allot a higher or lower share of Drawing Power to the member bank**, as against their share of Advance.

(₹ in Crores)

Banks	Share %	Limit / D.P.
State Bank of India	32.25	500.00
Bank of Baroda	2.58	40.00
Bank of India	6.45	100.00
Canara Bank	5.16	80.00
Standard Chartered Bank	9.03	140.00
Union Bank of India	6.45	100.00
HSBC	13.87	215.00
Citi Bank	6.45	100.00
Bank of America	1.29	20.00
BNP Parihas	1.94	30.00
Punjab National Bank	6.45	100.00
ICICI Bank	4.84	75.00
IDBI Bank	3.23	50.00
Unallocated	-	-
Total	**100.00**	**1550.00**

ACCOUNTS WHERE THERE IS EROSION IN THE VALUE OF SECURITY / FRAUDS COMMITTED BY BORROWERS

Erosion means **the gradual destruction or diminution of something not prudent** to follow stages of asset classification. It **should be straight-away classified as doubtful or loss asset** as appropriate as follows:

1) **Erosion in the value of security** can be reckoned as significant when the **realisable value of the security is less than 50 per cent of the value assessed by the bank** or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straight-away classified **under doubtful category** and provisioning should be made as applicable to doubtful assets.
2) If **the realisable value** of the security, **as assessed by the bank / approved valuers / RBI is less than 10 per cent of the outstanding in the borrowal accounts**, the existence of security should be ignored, and the asset should be **straight-away classified as loss asset**. It may be either written o or fully provided for by the bank.

ADVANCES AGAINST TERM DEPOSITS, NSC'S, KVPS/ IVPS, ETC.

Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need **not be treated as NPAs**, provided **adequate margin** is available in the accounts.

AGRICULTURAL ADVANCES AFFECTED BY NATURAL CALAMITIES

1) Master Circular issued by the RBI deals elaborately with the **classification and income recognition** issues due to impairment caused by natural calamities.
2) Banks may decide on their **own relief measures**, viz., conversion of the short-term production loan into a term loan or re-scheduling of the repayment period and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI's latest Master Circular on **Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances**.
3) In such cases, the NPA classification would be governed by such rescheduled terms.

ADVANCES TO STAFF

1) Interest bearing staff advances as a banker should be **included as part of advances portfolio of the bank**.
2) In the case of housing loan or similar advances granted to staff members where **interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards**.
3) Such loans/advances should be classified as NPA **only when there is a default in repayment of installment of principal** or payment of interest on the respective due dates.

4) The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head '**Others**' under the schedule of Other Assets.

AGRICULTURAL ADVANCES

1) As per the guidelines, Agricultural Advances are of two types,
   a) **Agricultural Advances for "long duration" crops and**
   b) **Agricultural Advances for "short duration" crops**
2) The **"long duration" crops** would be crops with crop season **longer than one year** and crops, which are not "long duration" crops would be treated as **"short duration" crops**.
3) The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the **State Level Bankers' Committee** in each State.
4) **The following NPA norms would apply to agricultural advances (including Crop Term Loans):**
   a) A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains **overdue for two crop seasons** and,
   b) A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains **overdue for one crop season**.

COMPUTATION OF DRAWING POWER

1) **Meaning:**

   Drawing Power generally addressed as **"DP"** is an important concept for Cash Credit (CC) facility availed from banks and financial institutions. **Drawing power is the limit** up to which a firm or company can withdraw from the working capital limit sanctioned.

2) **Different from Sanctioned Limit:**

   The **Sanctioned limit** is the total exposure that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc. On the other hand, **Drawing Power** refers to the amount calculated based on primary security less margin as on a particular date.

3) **Considerations:**

   All accounts should be kept within both the **drawing power and the sanctioned limit at all times**. The accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the **notice of the Management/Head Office regularly**.

4) **Bank's Duties:**

   Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at **based on current stock statement**. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power **should not be older than three months**. The outstanding in the account based on drawing power calculated from stock statements **older than three months is deemed as irregular**.

5) **Auditor's Concern:**

The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail. The audited Annual Report submitted by the borrower should be scrutinized properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

6) **Computation of DP:**

It needs to be ensured that the drawing power is calculated as per the **extant guidelines formulated by the Board of Directors of the respective bank** and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

7) **Stock Audit:** The stock audit should be carried out by the bank for **all accounts having funded exposure of more than 5 crores**. Auditors can also advise for stock audit in other cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

	Particulars of current assets			DP
(A)	**Stocks**			
	Stocks at realizable value		1000	
	Less: Unpaid stocks:			
	- Sundry creditors	300		
	- Acceptances/LCs etc.	300	600	
	Paid for stocks		400	
	Margin @ 25%		100	300
(B)	**Debtors**			
	Total Debtors		1000	
	Less: Ineligible debtors		200	
	Eligible debtors		800	
	Margin @ 40%		320	480
	Total DP			780

AUDIT OF ADVANCES

1) Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

2) **In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:**
   a) Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
   b) Advances represent amount due to the bank.
   c) Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
   d) There are no unrecorded advances.
   e) The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
   f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
   g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

3) The auditor can **obtain sufficient appropriate audit evidence** about advances by study and evaluation of internal controls relating to advances, and by:
   a) **examining the validity of the recorded amounts;**
   b) **examining loan documentation;**
   c) **reviewing the operation of the accounts;**
   d) **examining the existence, enforceability and valuation of the security;**
   e) **checking compliance with RBI norms including appropriate classification and provisioning; and**
   f) **carrying out appropriate analytical procedures.**

4) In carrying out his substantive procedures, the auditor should **examine all large advances** while **other advances may be examined on a sampling basis**. The accounts identified to be **problem accounts however need to be examined in detail** unless the amount involved is insignificant.

5) Advances which are sanctioned during the year or which are **adversely commented by RBI inspection team**, concurrent auditors, bank's internal inspection, etc. should **generally be included in the auditor's review.**

Evaluation of Internal Controls over Advances:

The auditor should **examine the efficacy of various internal controls** over advances to determine the nature, timing and extent of his substantive procedures. **In general, the internal controls over advances should include, *inter alia*, the following:**

1) The bank should make an advance **only after satisfying itself** as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
2) All the **necessary documents** (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be **executed by the parties before advances are made**.
3) The compliance with the **terms of sanction and end use of funds** should be ensured.
4) Sufficient margin as specified in the **sanction letter** should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
5) If the securities taken are in the nature of shares, debentures, etc., the **ownership of the same should be transferred in the name of the bank** and the effective control of such securities be retained as a part of documentation.
6) All securities requiring registration **should be registered in the name of the bank** or otherwise accompanied by documents su cient to give title to the bank.
7) In the case of **goods in the possession of the bank**, **contents of the packages should be test checked** at the time of receipt. The godown should be **frequently inspected by responsible officers** of the branch concerned, in addition to the inspectors of the bank.
8) Drawing Power Register should be **updated every month** to record the value of securities hypothecated. These entries should be checked by an officer.
9) The accounts should be kept **within both the drawing power and the sanctioned limit**.
10) All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be **brought to the notice of the controlling authority regularly**.
11) The operation of each advance account should be **reviewed at least once a year, and at more frequent intervals in the case of large advances**.

AUDIT OF REVENUE ITEMS

Profit and Loss Account: Sub-section (1) of section 29 of the Banking Regulation Act, 1949, requires the preparation of Profit and Loss Account in **Form B of Third Schedule to the Act** or as near thereto as the circumstances admit.

INCOME

The following items are included under this head:

Interest Earned	Other Income
a) Interest / Discount on Advances / Bills b) Interest Income on Investments c) Interest on Balances with RBI and Other Inter-bank Funds d) **Others:** This includes any other interest/discount income not included in the above heads	a) Commission, Exchange and Brokerage: **(Refer Note 1 Below).** b) Profit on Sale of Investments (net) c) Profit / Loss on Revaluation of Investments d) Profit on sale of Land, Buildings and Other Assets e) Profit/Loss on Revaluation of Fixed Assets f) Profit on exchange transactions: This includes revaluation gains/losses on forward exchange contracts and other derivative contracts, premium income/expenses on options, etc. g) Income earned by way of dividends, etc., from subsidiaries and joint ventures abroad / in India. h) Miscellaneous income.

Commission, Exchange and Brokerage

a) Commission on bills for collection.

b) Commission / exchange on remittances and transfers, e.g. demand drafts, NEFT, RTGS, etc.

c) Commission on letters of credit and guarantees, letter of comforts.

d) Loan processing, arranger and syndication fees.

e) Mobile banking fees.

f) Credit / Debit card fee income including annual fee income, merchant acquiring income, interchange fees, etc.

g) Rent from letting out of lockers

h) Commission on Government business.

i) Commission on other permitted agency business including consultancy and other services.

j) Brokerage on securities.

k) Fee on insurance referral.

l) Commission on referral of mutual fund clients.

m) Service / transaction banking charges including charges levied for transaction at other branches.

n) Income from rendering other services like custodian, de-mat, investment advisory, cash management and other fee-based services.

Audit Approach and Procedures

1) **Auditor's Concern:**

In carrying out an audit of income, the auditor is **primarily concerned with obtaining reasonable assurance** that the recorded income arose from transactions, which took place during the relevant period and pertain to the bank, that there is no unrecorded income, and that income is recorded at appropriate amount.

2) **RBI's Directions:**

RBI has advised that in respect of **any income which exceeds one percent** of the total income of the bank if the income is **reckoned on a gross basis or one percent of the net profit before taxes** if the income is reckoned net of costs, should be considered on accrual as per AS-9.

3) **Materiality:**

If any item of income is **not considered to be material as per the above norms**, it may be recognised when received and the auditors need not qualify their report in that situation.

4) **Revenue Certainty:**

Banks recognize income (such as interest, fees and commission) **on accrual basis, i.e., as it is earned**. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In modern day banking, the **entries for interest income** on advances are automatically generated through a **batch process in the CBS system**.

5) **Revenue Uncertainty:**

a) In view of the **significant uncertainty** regarding **ultimate collection of income** arising in respect of **non-performing assets**, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised.

b) When a credit facility is classified as **non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also**.

6) **Advances against Securities:**

Interest on advances against Term Deposits, National Savings Certificates (NSCs), Indira Vikas Patras (IVPs), Kisan Vikas Patras (KVPs) and Life policies **may be taken to income account on the due date, provided adequate margin is available in the accounts**.

7) **Bills Purchased:**

a) In the case of **bills purchased outstanding** at the close of the year the discount received thereon should be **properly apportioned between the two years**. [The Unexpired discount / rebate on bills discounted i.e., where part of receipt comprising discount charges on bills purchased relate to the period beyond the year-end, should be recorded as "Other Liabilities"].

b) **Interest (discount) component** paid by Bank/Branch on rediscount of bills from other financial institutions, is not to be netted o from the discount earned on bills discounted.

8) Bills for Collection:

a) In the case of **bills for collection**, the auditor should also **examine the procedure for crediting the party on whose behalf the bill has been collected**.

b) The procedure is usually such that the customer's account is **credited only after the bill has actually been collected** from the drawee either by the bank itself or through its agents, etc.

c) This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection.

d) The commission of the branch becomes due only when the bill has been collected.

9) Renegotiations:

a) **Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis** over the period of time covered by the re-negotiated or rescheduled extension of credit.

b) Test checks the Interest **earned by the banks for the sample selected**.

c) Test check the Fees and commissions earned by the banks made for commission on Bills for collection; Letters of credit; Bank Guarantees.

REVERSAL OF INCOME

1) If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the **entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.**

2) In respect of **NPAs, fees, commission and similar income** that have accrued should **cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.**

3) Further, in case of banks which have **wrongly recognised income** in the past should **reverse the interest** if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

4) Furthermore, the auditor should enquire if there are any **large debits in the Interest Income account that have not been explained**. It should be enquired is there are any communications from borrowers pointing out differences in Interest charge, and whether action as justified has been taken in this regard.

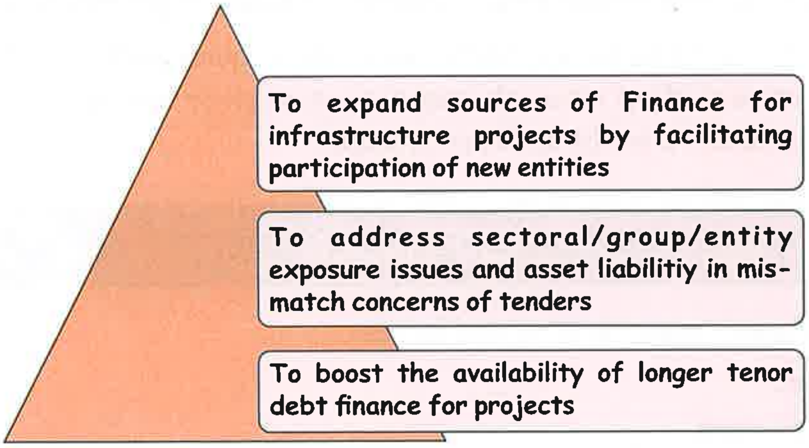
ON LEASED ASSETS

The component of finance income (as defined in AS 19 - Leases) on the leased asset which was accrued and credited to the income account before the asset became non-performing and remaining unrealised, should be reversed or provided for in the current accounting period.

ON TAKE-OUT FINANCE

1) A takeout loan is a method of financing whereby a loan that is procured later is used to replace the initial loan.
2) More specifically, a takeout loan, or takeout financing, is long-term financing that the lender promises to provide at a particular date or when particular criteria for completion of a project are met. Takeout loans are commonly used in **property development**.
3) In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should **not recognize income unless realised from the borrower/taking-over institution (if the arrangement so provides).**

OBJECTIVE OF TAKEOUT FINANCE



ON PARTIAL RECOVERIES IN NPAs

1) In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an **accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner**.
2) The appropriate policy to be followed is to **recognize income as per AS 9** when certainty attaches to realisation and accordingly amount reversed/derecognized or not recognised in the past should be accounted.
3) **Interest partly / fully realised in NPAs can be taken to income**.
4) However, it should be ensured that the **credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned**.

MEMORANDUM ACCOUNT

1) On an account turning NPA, banks should **reverse the interest already charged** and **not collected by debiting Profit and Loss account and stop further application of interest**.
2) However, banks may continue to **record such accrued interest** in a Memorandum account in their books for control purposes.
3) For the purpose of computing Gross Advances, interest recorded in the **Memorandum account should not be taken into account**.

INCOME FROM INVESTMENTS

1) **Interest Income on Investments:** This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. **Broken period interest paid on securities purchased and amortization of premium on SLR investments is net off from the interest income on investments**.
2) **Profit on Sale of Investments:** Investments are dealt in the course of banking activity and hence the **net profit or loss on sale of investments is taken to profit and loss account**.
3) **Profit/Loss on Revaluation of Investments:** In terms of guidelines issued by RBI, **investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised and taken to profit and loss account**.

EXPENSES

Expenditure is to be shown under three broad heads:

a) **Interest expense.**
b) **Operating expense; and**
c) **Provisions and contingencies.**

The following items are included under this head:

Interest Expense	Operating Expenses	Provisions and Contingencies
a) Interest on Deposits b) Interest on Reserve Bank of India / Inter-Bank Borrowings c) Others	a) Payments to and Provisions for Employees b) Rent, Taxes and Lighting c) Printing and Stationery d) Advertisement and Publicity e) Depreciation on Bank's Property	a) Provisions made in respect of the Non-performing assets. b) Provisions for Taxation

	f) Directors' Fees, Allowances and Expenses g) Auditors' Fees and Expenses h) Legal Expenses i) Postage, Telegrams, Telephones, etc. j) Repairs and Maintenance k) Insurance l) Marketing Expenses m) Other Expenditure	c) Provisions for Diminution in the value of investments d) Provisions for contingencies

AUDIT APPROACH AND PROCEDURES FOR INTEREST EXPENSE

1) In carrying out an audit of Interest expense, the auditor is primarily concerned with assessing the **overall reasonableness of the amount of interest expense by analyzing ratios** of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year.
2) In modern day banking, the entries for interest expenses are **automatically generated through a batch process in the CBS system.**
3) The auditor should **obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter.**
4) From such information, the auditor may work out a **weighted average interest rate.**
5) The auditor may then **compare this rate with the actual average rate of interest paid** on the relevant deposits as per the annual accounts and enquire into the di erence, if material.
6) The auditor should also compare the **average rate of interest paid** on the relevant deposits with the corresponding figures for the previous years and analyze any material differences.
7) The auditor should obtain **general ledger break-up for the interest expense** incurred on deposits (savings and term deposits) and borrowing each month/quarter.
8) The auditor should analyze **month on month (or quarter on quarter) cost analysis and document the reasons** for the variances as per the benchmark stated.
9) He should examine whether the **interest expense considered in the cost analysis agrees with the general ledger.**
10) The auditor should understand the process of **computation of the average balance and re-compute the same on sample basis.**
11) The auditor should, on a test check basis, **verify the calculation of interest** and satisfy himself that:
    a) **Interest has been provided on all deposits upto the date of the balance sheet; and verify whether there is any excess or short credit of material amount.**
    b) **Interest rates are in accordance with the bank's internal regulations, the RBI directives, and agreements with the respective depositors;**

c) **Interest on savings accounts are in accordance with the rules framed by the bank/RBI in this behalf.**

d) **Interest on inter-branch balances has been provided at the rates prescribed by the head office / RBI.**

12) The auditor should ascertain whether there are any **changes in interest rate** on saving accounts and term deposits during the period.

13) The auditor should obtain the **interest rate card** for various types of deposits and analyze the interest cost for the period accordingly.

14) The auditor should examine the **completeness that interest** has been accrued on the entire borrowing portfolio and the same should agree with the general ledgers.

15) The auditor should **re-compute the interest accrual** i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc. from the term sheet, deal ticket, agreements, etc. and ensure that the recomputed amount is tallying with the amount as per books of accounts without any significant difference.

AUDIT APPROACH AND PROCEDURES FOR AUDIT OF OPERATING EXPENSES

1) The auditor should **study and evaluate the system of internal control** relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.

2) The auditor should examine whether there are any **Divergent Trends** in respect of major items of Expenses.

3) The auditor should **perform an substantive analytical procedures** (proforma given below for reference) in respect of these expenses. **E.g.** assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

4) The auditor should **verify expenses with reference to supporting documents** and check the calculations wherever required.

AUDIT APPROACH AND PROCEDURES FOR PROVISIONS AND CONTINGENCIES

1) The auditor should **ensure that the compliances for various regulatory requirements** for provisioning as contained in the various circulars have been fulfilled.

2) **The auditor should obtain an understanding as to how the bank computes provision on standard assets and non- performing assets.**

3) It will primarily include checking the **basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non- performing assets.**

4) The auditor may verify the loan classification on a **sample basis**.
5) The auditor should **obtain the detailed break up** of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
6) The auditor should **obtain the tax provision computation** from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the **same are appropriately considered** in the tax provision computation.
7) Examine the other provisions for expenses vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

DISCLOSURE OF THE PRIOR PERIOD ITEMS

Since the format of the profit and loss accounts of banks prescribed in **Form B** under Third Schedule to the Banking Regulation Act, 1949 **does not specifically provide for disclosure of the impact of prior period items** on the current year's profit and loss, such disclosures, wherever warranted, may be given.

ETHICS AND TERMS OF AUDIT ENGAGEMENTS

MEANING OF ETHICS – A STATE OF MIND

1) The term **"Ethics"** means moral principles which govern a person's behaviour or his conducting of an activity. It is the **branch of knowledge** that deals with moral principles. Ethics is something which comes from an individual intrinsically.
2) It has to **be inculcated** in the habit and temperament of an individual, so that there is an overall culture of ethics; the force has to be strong enough to withstand any selfish motive or temptation.
3) It is a **state of mind to act and perform** in accordance with moral principles. Ethics is the science of morals in human conduct. Such moral principles and rules of conduct impose obligations upon individuals.

NEED FOR PROFESSIONAL ETHICS

1) Professions like law, medicine have their code of ethics. Auditing profession is no exception. Rather, in the profession of auditing, requirement of ethics is manifold.
2) It is due to the reason that society in general, governments, clients, taxing authorities, employees, investors, the business and financial community in particular, have reposed tremendous trust in services rendered by Chartered Accountants.
3) The **purpose** of assurance engagements is **to enhance confidence** of the intended users. Therefore, users need to trust the person who is providing such services.
4) Professional ethics are based on **morality**. Human nature being what it is, a man, often, places his personal gain above service. Therefore, persons who as individuals and as a class, are willing to place public good above their personal gain have enjoyed respect and honour.
5) But such a relationship can be **maintained or enhanced** only if the professional body to which they belong would interpret the concept of public interest as broadly as possible.
6) The respect and confidence enjoyed by a profession, to a great extent, is dependent on the **strictness and scrupulousness** with which such ethics are adhered to by self-discipline.
7) A distinguishing feature of the accountancy profession is its **acceptance of the responsibility to act** in the public interest. Professional ethics seek to protect the interests of the profession as a whole and act as a shield that enables us to command respect.
8) ***A Chartered Accountant, either in practice or in service***, has to abide by ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their duties.
9) Service users of professionals should be able to feel secure that there exists a framework of professional ethics which governs the provision of those services.
10) It is in this spirit of things that the Institute of Chartered Accountants of India (ICAI) requires its members **to comply with the principles of ethics** while **performing their duties**.
11) The ethics for Chartered Accountants have, therefore, been codified as ethical compliance has always been a philosophy of the profession.

12) Chartered accountants, whether in practice or in service, are required to comply with the provisions of Code of Ethics.
13) Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants which may result into fines, suspension of membership, removal from membership or other disciplinary actions.

PRINCIPLES BASED APPROACH VS RULES BASED APPROACH TO ETHICS (ETHICAL OR LEGAL)

1) Ethical guidance may follow **principles-based approach or rules-based approach**. The essence of principles-based approach to ethics is that it **requires compliance with spirit of ethics**.
2) It requires accountants **to exercise professional judgment** in every situation based upon their professional knowledge, skill and expertise.
3) It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions. However, **rules-based approach** to ethics **strictly follows clearly established rules**.
4) It may **lead to a narrow outlook** and **spirit of ethics** may be overlooked while strictly adhering to rules.
5) Further, rules- based approach is somewhat **rigid** as it may not be possible to deal with every practical situation relying upon rules. Therefore, it is necessary that **spirit of code** is followed.

FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

The fundamental principles of ethics establish the standard of behaviour expected of a professional accountant. **A professional accountant** shall comply with each of the fundamental principles. The fundamental principles of professional ethics are as under: -

1) Integrity

a) **A professional accountant** shall comply with the principle of integrity, which requires an accountant **to be straightforward and honest** in all professional and business relationships.
b) Integrity implies **fair dealing and truthfulness**.
c) A professional accountant shall **not knowingly be associated** with reports, returns, communications or other information where the accountant believes that the information **contains a materially false or misleading statement**; contains statements or information provided **negligently or omits or obscures** required information where such omission or obscurity would be misleading.

2) Objectivity

a) The principle of objectivity requires an auditor **not to compromise professional judgment** because of **bias, conflict of interest or undue influence** of others.

b) It requires that **a professional accountant** shall **not** undertake a professional activity if a **circumstance or relationship** unduly influences the accountant's professional judgment regarding that activity.

3) Professional competence and due care

a) A professional accountant shall comply with the **principle of professional competence and due care**, which requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and act diligently and in accordance with applicable technical and professional standards.

b) Diligence includes responsibility **to act carefully, thoroughly and on a timely basis** in accordance with requirements of an assignment.

4) Confidentiality

a) Confidentiality principle requires **a professional accountant** to respect the **confidentiality of information** acquired as a result of professional or business relationships.

b) Confidentiality serves the public interest because it **facilitates the free flow of information** from the professional accountant's client or employing organization to the accountant with the **understanding** that the information will **not be disclosed** to a third party.

c) However, such confidential information **may be disclosed**, for example, **when it is required by law**, when it is **permitted by law** and is **authorised by the client or employer** or there is a professional duty or right to disclose when not prohibited by law.

5) Professional Behaviour

a) It requires an accountant **to comply with relevant laws and regulations** and avoid any conduct that the accountant knows or should know might discredit the profession.

b) A professional accountant shall **not** knowingly **engage** in any employment, occupation or activity that **impairs or might impair** the in**tegrity, objectivity or good reputation** of the profession, and as a result would be incompatible with the fundamental principles.

INDEPENDENCE OF AUDITORS

1) **Professional integrity and independence** are essential characteristics of all the professions but are more so in the case of accountancy profession.
2) **Independence** implies that the **judgement of a person is not subordinate** to the **wishes or direction** of **another person** who might have **engaged him, or to his own self-interest**.
3) It is not possible to define "**independence**" precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules, by themselves, **cannot** create or ensure the existence of independence.
4) Independence is a **condition of mind as well as personal character** and should **not be confused** with the **superficial and visible standards** of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered.
5) There are **two interlinked perspectives** of independence of auditors, one, independence of mind and two, independence in appearance. Independence is:
   a) **Independence of mind** - the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and
   b) **Independence in appearance** - the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.
6) Independence of the auditor has **not only to exist in fact, but also appear to so exist** to all reasonable persons. The relationship between the auditor and his client should be such that firstly, he is himself satisfied about his independence and secondly, no unbiased person would be forced to the conclusion that, on an objective assessment of the circumstances, there is likely to be an abridgement of the auditors' independence.
7) Independence of an auditor **assumes significance** in context of providing confidence to users of financial statements.
8) As statutory auditor of a listed company, **for example**, the Chartered Accountant would cease to perform any useful function if the persons who rely upon the accounts of the company do not have any faith in the independence and integrity of the Chartered Accountant.
9) In such cases, he is **expected to be objective** in his approach, fearless, and capable of expressing an honest opinion based upon the performance of work such as his training and experience enables him to do so.
10) Independence is **dependent** on the **state of mind and character** of a person and is a very subjective matter. One person might be independent in a particular set of circumstances,

while another person might feel he is not independent in similar circumstances.

11) It is therefore the duty of every Chartered Accountant to determine for himself whether or not he can act independently in the given circumstances of a case and quite apart from legal rules, in no case to place himself in a position which would compromise his independence.

THREATS TO INDEPENDENCE

Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken.

In addition, the nature of assurance engagements may differ and consequently different threats may exist requiring the application of different safeguards.

Following five types of threats to independence of auditors are discussed below: -

1) Self-interest threats

a) Self-interest threats occur when an **auditing firm**, its **partner or associate could benefit from a financial interest in an audit client**.

b) **Examples include**

(i) direct financial interest or materially significant indirect financial interest in a client

(ii) loan or guarantee to or from the concerned client

(iii) undue dependence on a client's fees and, hence, concerns about losing the engagement

(iv) close business relationship with an audit client

(v) potential employment with the client and

(vi) contingent fees for the audit engagement

2) Self-review threats

a) **Self-review threats** occur when **during a review** of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client.

b) **Non audit services** include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service etc.

c) **Instances** where such threats come into play are: -

(i) when an **auditor** having recently **been a director or senior officer** of the company.

(ii) when auditors **perform services** that are themselves subject matters of audit.

3) Advocacy threats

a) Advocacy threats occur when the auditor **promotes, or is perceived to promote**, a client's opinion to a point where people may believe that **objectivity is getting compromised**,

b) **For Example** : when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.

c) In such situations, auditor **can be perceived** as backing and championing causes of auditee client and it may lead to belief that audi**tor is not acting and working objectively**.

4) Familiarity threats

a) Familiarity threats are **self-evident**, and occur when **auditors form relationships with the client** where they end up being too sympathetic to the client's interests.

b) This can occur in many **ways** including:

(i) **close relative** of the audit team working in a senior position in the client company

(ii) **former partner** of the audit firm **being a director** or **senior employee** of the client

(iii) **long association** between specific auditors and their specific client counterparts and

(iv) **acceptance of significant gifts or hospitality** from the client company, its directors or employees.

c) Provisions in **Companies Act, 2013 regarding rotation of auditors** mainly address these very familiarity threats. Such provisions prescribe that auditor is rotated after a certain number of years so that auditors do not become too familiar with their clients.

5) Intimidation threats

a) Intimidation threats occur when auditors are **deterred from acting objectively** with an adequate degree of professional skepticism.

b) Basically, these could happen because of **threat of replacement over disagreements** with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees or being threatened with litigation.

c) Such threats attempt to **intimidate auditors** to deter them from acting objectively.

SAFEGUARDS TO INDEPENDENCE

1) **Chartered Accountants** have a responsibility **to remain independent** by taking into account the context in which they practice, the threats to independence and the safeguards available to address the threats.

2) **Safeguards are actions**, individually or in combination, that the professional accountant takes that **effectively reduce** threats to comply with the fundamental principles to an acceptable level.

3) To address the issue, the **following guiding principles** are to be applied: -
   a) For the public to have confidence in the quality of audit, it is essential that auditors should **always be and appears to be independent** of the entities that they are auditing.
   b) Before taking on any work, an auditor **must conscientiously consider** whether it **involves threats to his independence**.
   c) When such threats exist, the auditor should **either desist from the task or eliminate the threat** or at the very least, **put in place safeguards** which reduce the threats to an acceptable level. All such safeguards' measures need to be recorded in a form that can serve as evidence of compliance with due process.
   d) If the auditor is **unable to fully implement** credible and adequate safeguards, then he **must not accept the work**.

PROFESSIONAL SKEPTICISM

1) **Professional skepticism** refers to an **attitude** that **includes a questioning mind, being alert to conditions** which may **indicate possible misstatement** due to error or fraud, and a critical assessment of audit evidence.
2) It **signifies** that auditor **has to remain alert forever**. The **auditor's attitude** should be of **questioning mind- of** challenging the things in light of available evidence.
3) The auditor shall **plan and perform** an audit with professional skepticism recognising that circumstances may **exist** that cause the financial statements to be materially misstated.
4) Professional skepticism includes being alert to, **for example**:
   a) Audit evidence that **contradicts** other audit evidence obtained.
   b) **Information** that **brings into question the reliability of documents** and responses to inquiries to be used as audit evidence.
   c) **Conditions** that may **indicate possible fraud**.
   d) **Circumstances** that suggest the need for audit procedures in addition to those required by the SAs.
5) **Maintaining professional skepticism** throughout the audit is necessary if the auditor is to reduce the **risks of**:
   a) **Overlooking** unusual circumstances.
   b) **Over generalising** when drawing conclusions from audit observations.
   c) **Using inappropriate assumptions** in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.
6) Professional skepticism is necessary **to the critical assessment of audit evidence**. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances,

   For example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

7) The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required **to consider the reliability of information** to be used as audit evidence.

8) In cases of **doubt** about the reliability of information or indications of possible fraud, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

9) The auditor **cannot** be expected **to disregard** past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does **not relieve** the auditor of the **need to maintain professional skepticism.**

REFER SA 210, 220 & SQC 1 FROM SA MODULE 1.

About the Author

CA Rishabh Jain

- Having cracked the CA exam at the **age of 21**. RJ Sir became one of the youngest Chartered Accountants in India.
- He simplifies all concepts in the easiest way possible.
- His Extra-ordinary rapport/contact with students, make him highly accessible for their numerous difficulties.
- He is always available for Advice, related to CA course and beyond the course.
- He applies **simulation techniques** used by MNC's and Big 4's and provides example of actual & audit setting which in turn gives students a peek into industry methodologies.
- Only Audit Professor in India with more than **6 years'** experience in Big 4s **(PWC & Deloitte)**.
- He has mentored over 20,000 students in a short span of **10 years**.
- Engages students with real-world scenarios, from his prior experience with Fortune 500 clients.
- Mentored many of his students who are now successful professionals.
- Placed many of his students in Big Four firms across India.
- Conducts exclusive speaker sessions on Startups and New Emerging Technologies.

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Office No 70 & 71, 2nd Floor, Prestige Point

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