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AUDIT PROCEDURE FOR PROPERTY PLANT AND EQUIPMENT

COMPLETENESS

- Verify the movement in the PPE schedule compiled by the management i.e. **Opening balances + Additions during the period – Deletions during the period = Closing balances**. Tally the closing balance to the entity's books of account.
- Check the arithmetical accuracy of the movement in PPE schedule. Tally the opening balances to the previous year audited financial statements.

For additions and deletion during the period under audit, obtain a listing of all additions from the management and perform the following procedures:

In relation to Addition to PPE,

- 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.
- 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.
- Verify whether the PPE additions have been approved by authorized personnel.
- Items such as spare parts, stand-by equipment and servicing equipment are recognized in accordance with AS 10 (Revised) when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory. 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.

In relation to deletions to PPE,

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

EXISTENCE

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

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

- 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.
- 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.
- 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.

RIGHT & OBLIGATION

- 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.
- land and building** the auditor should check the **conveyance deed/ sale deed** to verify whether the entity is the legal and valid owner or not.
- The auditor should insist and verify the **original title deeds for all immoveable properties** held as at the balance sheet date.
- 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.
- 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.

VALUATION

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. 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. The auditor should:

- Verify that the entity has **charged depreciation on all items** of PPE unless any item of PPE is non- depreciable like freehold land;
- 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.
- 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.



AUDIT PROCEDURE FOR PROPERTY PLANT AND EQUIPMENT

Land, Building, Plant & Equipment, Furniture & Fixtures, Vehicles, Office Equipment, Computers etc. referred to AS "Property, Plant And Equipment" ("PPE")

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.

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.

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

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

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.

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.

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 summarises the audit procedures generally required to be undertaken while auditing tangible fixed assets.

AUDIT OF DEPRECIATION AND AMORTIZATION

a) Meaning and purpose of Depreciation

AS 10 "Property, Plant & Equipment" defines depreciation as the systematic allocation of the depreciable amount of an asset over its useful life.

Purposes of Depreciation

- (a) To provide the funds for the replacement of assets: This is accomplished by retaining the amount of depreciation charged in the profit and loss account in the business.
- (b) To determine true cost of manufactured goods: As the value of fixed assets depletes gradually by consumption during the process of production, it is necessary that such consumption of value be charged in the accounts for determination of the true cost of production.
- (c) To determine the profit or loss for the year: Depreciation being an expense represented by the loss in value of fixed assets arising on use, it is charged to the profit and loss account for determining the profit or loss during a year.
- (d) To show a true and fair value of entity's assets in the balance sheet: since the original costs of fixed assets gradually decreases due to use and other factors, it is improper to continue to carry such assets at original costs. Therefore, the amount of depreciation charged in the profit and loss account representing the loss in value of the assets is deducted from the original cost on a cumulative basis so as to reflect in the balance sheet a true and fair value of the fixed assets.

Auditor's Duty

The auditor should pay attention to the following points:

- i. Understand and evaluate the adequacy and effectiveness of internal controls as regards accounting, maintenance and safeguarding of fixed assets and that a proper distinction is being made between capital expenditure and revenue expenditure.
- ii. Check that the amount of depreciation is accurately calculated considering the acquisitions or disposal, if any, of the fixed assets during the year.
- iii. Ensure that the company has complied with the requirements of AS 10 on Property, Plant and Equipment.
- iv. Also ensure that the provisions of Section 123(1) of the Companies Act have also been complied with by the company.
- v. Perform analytical procedures to obtain audit evidence as to overall reasonableness of depreciation and amortisation expense.



BORROWING

COMPLETENESS

(Movement Check = Op Bal + Addition Audit – Deletion Audit = Closing Balance)

Obtain a schedule of short term and long term borrowings (including debts 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.

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. (Eg: Fresh loan taken near the balance sheet date)

Direct confirmation procedures – SA 505 (No Need to Read in Final Revision)

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, collateral and security interests).
- (b) Send reminders for non-replies.
- (c) Compare the balances as 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.

EXISTENCE

- **Review board minutes for approval of new lending agreements.** During review, ensure that new loan agreements or bond issuances were authorized. Ensure that significant debt commitments were approved by the board of directors.
- **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.
- **Roll out and obtain independent balance confirmations** (SA 505) in respect of all the borrowings from the lender (banks/ financial institutions etc.).
- Agree details of leases and hire purchase creditors recorded to underlying contracts/agreements.
- **In case of Debentures**, examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- **When debt is retired**, ensure that a discharge is received on assets securing the debt.
- **Obtain Written Representation** that all the liabilities which have been recorded represent a valid claim by the lenders.

VALUATION

General Points (Only Read)

- 1- Determine that the **accounting policies and methods** of recording debt are appropriate and applied consistently.
- 2- 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**.
- 3- He should carefully review the borrowings from related parties and ensure compliance with **AS 18 or IND AS 24**.
- 4- Verify that the company has not contravened the restrictions laid down by Section 180 (related to Restrictions on Powers of Board) of the **Companies Act, 2013** in respect of the borrowings of the company. Also, check compliance of Sections 185 (related to Loans to Directors, etc.) and 186 (related to Loan and Investment by company) of the Companies Act, 2013.
- 5- **Examine the purpose** for which the amount is borrowed and ensure that the amount is not used against the interest of the company.
- 6- **Agree loan balance and loan payables** to the loan agreement.
- 7- **Examine the due dates on loans for proper classification** between long-term and short-term.

Special Points (Learn them)

- 1- **Recompute the interest and discount** or premium on redemption, if any. Check computation of the amortization of premium or discount, if any.
- 2- **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)
- 3- **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. 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.



INTANGIBLE ASSETS

COMPLETENESS

a. **Verify the movement in the intangible assets schedule** (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e. Opening balances + Additions – Deletions = Closing balances.

Tally the closing balances to the entity's books of account.

b. Check the arithmetical accuracy of the movement in intangible assets schedule.

Audit of Addition of Intangible

For additions during the period under audit, obtain a listing of all additions from the management and undertake the following procedures:

- For all material additions**, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.
- 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.
- Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.
- 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.

Audit of Deletion of Intangible

For deletion during the period under audit, obtain a listing of all deletion from the management and undertake the following procedures:

- In relation to deletions of intangible assets, understand from the management the reason and rationale for deletion and the manner of disposal.
- Obtain the management approval and disposal note authoring disposal 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.
- 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 disposal in the entity's books of account.

EXISTENCE

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 1- 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 2- 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.

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 beyond the date of deletion.

RIGHT & OBLIGATION

- 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 entity.

VALUATION

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. 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. The auditor should:

- Verify that the entity has charged amortization on all intangible assets;
- 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.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired. For this purpose, the auditor needs to verify whether the entity has applied AS 28 - Impairment of Assets for determining the manner of reviewing the carrying amount of its intangible asset, determining the recoverable amount of the asset to determine impairment loss, if any.

LOANS AND ADVANCES AND OTHER CURRENT ASSETS

COMPLETENESS

Movement Check (Op+Addition-Deletion = Closing)

- Obtain a list of all advances** and other current assets and compare them with balances in the ledger.
- 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.
- 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.
- Inspect the minutes of meeting of board** of directors to confirm if all material loans and advances were approved by the board of directors.
- 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. Ascertain if loans are being recovered regularly as per agreed instalments.
- 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.
- 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.
- 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.

EXISTENCE

Confirmation (SA 505) – No Need to read before exam

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 performing circularisation of direct confirmations, in addition to the principal amount, interest receivable, if any, as per the agreed terms between the parties, may also be included as part of the balance to be confirmed.

VALUATION

- Assess the allowance for doubtful accounts.** Review the process followed by the Company to derive an allowance for doubtful accounts. 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.
- Obtain the ageing report of loans and advances.** Also, obtain the list of loans and advances under litigation and compare with previous year.
- 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.
- Assess bad loans/ advances write-offs.** Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off.
- Check that write-offs or other reductions** in the recoverable balances have been approved by the authorised and appropriate senior authority
- Check that the restatement of foreign currency** loans and advances/ other current assets has been done properly in accordance with AS 11



AUDIT OF TRADE RECEIVABLES

ESSENTIAL FEATURES OF INTERNAL CONTROLS W.R.T. TO TRADE RECEIVABLES

In relation to credit sales, it becomes imperative to carry out compliance procedures so as to ensure that the system for receivables has the following features:

1. Only bona fide sales lead to receivables.
2. Sales are made only to approved customers.
3. All such sales are duly recorded in the books.
4. Once recorded, the debts can only be eliminated by receipt of cash or on the approval by a responsible official.
5. Debts are collected promptly.
6. Balances are regularly reviewed and aged, a proper system of follow up exists and if necessary adequate provision for bad debt exists.
7. Clear segregation of duties relating to identification of debt, receipt of income, reconciliations and write off of debts.

AUDIT PROCEDURE

A. EXISTENCE

- ▲ 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.
- ▲ Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger.
- ▲ 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. If realization is made on account, verify whether the Company has obtained confirmations from debtors in respect of the same.
- ▲ If any large balance is due for a long time, auditor should ask for reasons and justification for the same.

C. VALUATION

- ▲ Review the process followed by the Company to derive an allowance for doubtful accounts.
- ▲ Obtain the ageing report of accounts receivable (both Dr/Cr balance).
- ▲ Also, obtain the list of debtors under litigation and compare with previous year.
- ▲ Scrutinize the analysis and identify those debtors which appear doubtful; discuss with management about reasons as to why these debtors are not included in the provision for bad debts. Perform further testing where any disputes exist.
- ▲ He should check if provisions are made at appropriate rates considering the recoverability of amounts due.

B. COMPLETENESS

The auditor needs to satisfy himself of the cut-offs. Without a cut-off, sales could be understated or overstated, hence there is a need to perform the following cut off procedure:

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

(II) DIRECT CONFIRMATION PROCEDURE

1. The auditor employs direct confirmation procedure with the consent of the entity under audit. If management does not allow the auditor to seek confirmation from certain trade receivables, the auditor should consider whether there are valid grounds for such a request.
2. While determining the information to be obtained, the auditor should consider all relevant factors such as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts and the materiality of the amounts involved.
3. The trade receivables 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.
4. Where the auditor decides to confirm the trade receivables at a date other than the balance sheet date, he should examine the movements in debtor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that debtor balances stated in the balance sheet are not materially misstated.
5. The form of requesting confirmation from the trade receivables may be either (a) the 'positive' form of request or (b) the 'negative' form of request.
6. Where positive form of request is used, the auditor may, in appropriate cases, request the entity to follow up with a reminder to those trade receivables from whom he receives no replies.
7. 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. The entity should be asked to investigate and reconcile the discrepancies.
8. 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 receivables taken as a whole.

(III) ANALYTICAL REVIEW PROCEDURES

Auditor may also perform below mentioned analytical review procedures as a means of obtaining audit evidence regarding the various assertions relating to trade receivables, loans and advances:

- (a) comparison of closing balances of trade receivables, loans and advances with the corresponding figures for the previous year;
 - (b) comparison of the relationship between current year debtor balances and the current year sales with the corresponding figures for the previous year;
 - (c) comparison of actual closing balances of trade receivables, loans and advances with the corresponding budgeted figures, if available;
 - (d) comparison of current year's aging schedule with the corresponding figures for the previous year;
 - (e) comparison of significant ratios relating to trade receivables, loans and advances with the similar ratios for other firms in the same industry, if available;
 - (f) comparison of significant ratios relating to trade receivables, loans and advances with the industry norms, if available.
- 1 **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.
 - 2 **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.
 - 3 **Purchase invoice should be in the name of entity.** However, in case of different branches, it should be addressed to the appropriate branch.
 - 4 **Input tax component should have been booked in the input tax ledger.** The auditor should obtain tax returns filed with the authorities and tally the input tax as reflected in the books to the amount disclosed in the returns.
 - 5 **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.
 - 6 **The auditor should review whether purchases should be capitalized or expensed off** in Statement of Profit and loss according to his professional judgement.
 - 7 **Compliance of special conditions:** If supplies are received on certain special conditions, verified that these conditions are the same as were agreed to at the time the order was placed, e.g., payment of freight and insurance charges of goods while in transit, etc.
 - 8 **Timings of Payment:** If the amount of an invoice was payable after the lapse of some time, subsequent to the receipt of goods, it should be ascertained that it has not been paid earlier and the benefit of cash discount, if any, has been obtained.
 - 9 **Inspection before taking delivery:** Ensure that the goods were inspected on arrival and the delivery note and the goods inward note should be examined.



AUDIT OF PURCHASES

AUDIT PROCEDURE

Steps to be followed

- Identify the control points over purchases.
- Tests the identified controls to determine how strong and reliable they are. If controls are assessed as strong, the auditor can reduce the amount of substantive testing.
- Selects a random sample of transactions and examines the related purchase orders, Goods Received Note (GRN), purchase invoices, inward gate entry register and vendor reconciliation/ statements.
- Performing substantive audit procedures like vouching and substantive analytical procedure (SAP). SAP will consist of purchase trend analysis, comparison of purchase figures with previous accounting period etc.
- **Verification of revenue may be carried out by employing the following procedures:**
 - (a) Examination of records;
 - (b) Analytical review procedures.

AUDIT PROCEDURE

Ensure purchases are not understated/ overstated by performing following audit procedures: (O)

- ▲ 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.
- ▲ Whether the goods were received at the factory gate and whether there exists an entry in the security gate inward register.
- ▲ Whether quality inspection of goods was done.
- ▲ Whether a goods receipt note was prepared and signed by an appropriate client personnel.
- ▲ Whether the purchase invoice was approved as per delegation of authority and whether a 3 or 2-way match (as discussed above) was done.
- ▲ Whether stock record has been updated by the stores personnel.

Special considerations during audit of purchases/SPECIAL PRECAUTIONS IN VERIFICATION OF PURCHASE INVOICES

- 1 **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.
- 2 **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.
- 3 **Purchase invoice should be in the name of entity.** However, in case of different branches, it should be addressed to the appropriate branch.
- 4 **Input tax component should have been booked in the input tax ledger.** The auditor should obtain tax returns filed with the authorities and tally the input tax as reflected in the books to the amount disclosed in the returns.
- 5 **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.
- 6 **The auditor should review whether purchases should be capitalized or expensed off** in Statement of Profit and loss according to his professional judgement.
- 7 **Compliance of special conditions:** If supplies are received on certain special conditions, verified that these conditions are the same as were agreed to at the time the order was placed, e.g., payment of freight and insurance charges of goods while in transit, etc.
- 8 **Timings of Payment:** If the amount of an invoice was payable after the lapse of some time, subsequent to the receipt of goods, it should be ascertained that it has not been paid earlier and the benefit of cash discount, if any, has been obtained.
- 9 **Inspection before taking delivery:** Ensure that the goods were inspected on arrival and the delivery note and the goods inward note should be examined.

COMPLETENESS & MEASUREMENT

In addition to the procedures for establishing occurrence of purchases as discussed above, the auditor should:

- Perform cut-off test
- 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.
- Obtain written representation from the management that all the purchases that took place during the year have been properly recorded in the books.

ANALYTICAL PROCEDURES (C&M)

Perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include:

- i. **Consumption Analysis:** Auditor should examine consumption of raw material from manufacturing account and compare the same with previous years with closing stock and ask for the reasons from management for any significant variations noticed.
- ii. **Stock Composition Analysis:** Auditor should collect 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 for any significant variations noticed.
- iii. **Ratios:** Auditor should compare the creditors' turnover ratios and stock turnover ratios of the current year with previous years.
- iv. **Quantitative Reconciliation:** Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.



AUDIT OF INVENTORIES

EXAMINATION OF VALUATION & DISCLOSURES (V&P)

- i. The auditor should satisfy himself that the valuation of inventories is in accordance with the AS 2, "Valuation of Inventories".
- ii. The auditor should examine the evidence supporting the assessment of NRV. In this regard, the auditor should particularly examine whether appropriate allowance has been made for defective, damaged and obsolete and slow-moving inventories in determining the NRV.
- iii. The auditor should satisfy himself that the inventories have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

a) For Raw materials and consumables

- I Ascertain what elements of cost are included e.g. carriage inward, non-refundable duties etc.
- I 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.
- I Test check cost prices used with purchase invoices received in the month(s) prior to counting.
- I 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.

b) For Work in progress

To carefully assess the stage of completion of the WIP for assessing the appropriateness of its valuation, the auditor may perform the following:

- hold discussions with the personnel concerned, and
 - Ascertain how the various stages of production/ value additions are measured and in case estimates are made, understand the basis for such estimates.
 - Ascertain what elements of cost are included. 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.

- Ensure that material costs exclude any abnormal wastage factors.

- obtain expert opinion, where necessary.

c) For Finished goods and goods for resale

- I 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.
- I Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials have also been written down.

d) Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. Carefully examine the valuation of obsolete and damaged inventory.

For the purpose, request the client to provide **inventory ageing split and follow up** for any inventories which at time of observance of physical counting were noted as being damaged or obsolete.

- I Compare recorded costs with replacement costs.
- I Examine vendor price lists to determine if recorded cost is less than current prices.
- I Calculate inventory turnover ratio. Obsolete inventory may be revealed if ratio is significantly lower.
- I In manufacturing environments, test overhead allocation rates and ensure that only direct labor, direct material and overhead have been included.
- I Verify the correct application of lower-of- cost-or-net realizable value principles.

AUDITOR'S PROCEDURES FOR VERIFICATION

Verification of inventories may be carried out by employing the following procedures:

- (a) examination of records;
- (b) attendance at stock-taking;
- (c) obtaining confirmations from third parties;
- (d) examination of valuation and disclosure; and (e) analytical review procedures.

The NTE of audit procedures to be performed is, however, a matter of professional judgment of the auditor.

ATTENDANCE AT STOCK-TAKING (E)

- (a) The physical verification of stock is the responsibility of the management. The auditor may find it appropriate to attend the stock taking, if the inventory value is material in his opinion.
- (b) The extent of participation in inventory taking depends upon the internal control system prevailing, results of examination of inventory records and analytical review procedures.
- (c) When auditor attend inventory taking, he ensure that the instructions given for inventory taking is followed.
- (d) He test checks few items by himself for their existence and quantum. He selects to test high value items importantly.
- (e) The physical conditions of stock - like its age, deterioration, obsolescence etc., are looked into by auditor.
- (f) The auditor reviews stores records and notes down major discrepancies for reconciling them in a subsequent date.
- (g) The cut off arrangement is also looked into ensure that the entity accounts for stock for which liability had been booked and excludes stock which had been sold.

EXAMINATION OF RECORDS (C)

- a. Auditor should examine the stock records with reference to the relevant basic documents like goods received notes, inspection reports, material issue notes, bin cards, etc.
- b. If the entity does not maintain detailed stock records, the auditor would have to suitably extend the extent of application of other audit procedures.
- c. Examine non-financial information related to inventory, such as weights and other measurements.
- d. 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.
- e. With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.
- f. Verify the clerical and arithmetical accuracy of inventory listings.

CONFIRMATIONS FROM THIRD PARTIES (E)

- Where significant stocks of the entity are held by third parties, the auditor should examine that the third parties are not such with whom it is not proper that the stocks of the entity are held.
- The auditor should also directly obtain from the third parties written confirmation of the stocks held.
- Arrangements should be made with the entity for sending requests for confirmation to such third parties.



AUDIT OF INVENTORIES

VERIFICATION OF GOODS ON CONSIGNMENT R

Such transaction should be vouched and verified as under—

- Vouch the Proforma invoice sent with goods to ascertain the quantity and value of goods sent.
- Freight evidences given by the transporter like Challan, Bill, Receipt for freight charged.
- Insurance charge to be verified from cover note and premium paid receipt issued by Insurance Company.
- Account sale sent by consignee, referring to sale price of the goods sold, expenses incurred by him and stock remained unsold.
- Obtain confirmation from consignee for the goods held on consignment on balance sheet date.
- Unsold goods should have been taken in the closing stock valued properly inclusive of expenses (Proportionate) incurred by consignee.
- Journal entries relating to such transaction be verified from the books of the Company.

ANALYTICAL REVIEW PROCEDURES

Auditor may also apply following analytical review procedures so as to obtain audit evidence regarding the various assertions:

- Reconciliation of quantities of opening stocks, purchases, production, sales and closing stocks;
- Comparison of closing stock quantities and amounts with those of the previous year;
- Comparison of the relationship of current year stock quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;
- Comparison of the composition of the closing stock [e.g., raw materials as a percentage of total stocks, WIP as a percentage of total stocks] with the corresponding figures for the previous year;
- Comparison of current year gross profit ratio with the gross profit ratio for the previous year;
- Comparison of actual stock, purchase and sales figures with the corresponding budgeted figures, if available;
- Comparison of yield with the corresponding figure for the previous year;
- Comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;
- Comparison of significant ratios relating to inventories with the industry norms, if available.

CASH AND CASH EQUIVALENTS

Required DISCLOSURES for cash and cash equivalents have been appropriately made

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

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.



AUDIT OF EMPLOYEE BENEFIT EXPENSE

AUDIT PROCEDURE

- i) Obtain an understanding of process of recording employee attendance.
- ii) Obtain a list of employees along with a monthly movement split between new hires, leavers and continuing employees.
- iii) In case of new employees, select few cases on random basis and obtain the appointment letter and verify whether the salary for first month and subsequent months was processed as per the agreed terms.
- iv) In case of employees who resigned, select few cases on random basis and 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.
- v) Obtain the monthly salary registers for the complete year. Compile a monthly payroll reasonability by calculating the average salary per employee per month and compare with the previous year and preceding month.
- vi) Verify whether provision has been made for all employee benefits and obligations like bonus, gratuity, and leave encashment.
- vii) In case provident fund (PF), employee state insurance (ESI) are applicable to the entity, determine a reasonable amount by applying the rate to the basic wages and comparing to the amount recorded in books and analyse reasons for variance, if any.
- viii) Perform analytical procedures to obtain audit evidence as to overall reasonableness of employee benefit expense.

AUDIT OF OTHER INCOMES (Int., Div, Profit/Loss on sale of Investments etc.)

RECOGNITION OF INCOME

Interest on Fixed Deposits

Interest income on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.

Interest Income from debt instruments

Interest income from debt instruments is recognized using the effective interest rate method.

Dividend

Dividends are recognised in the statement of profit and loss only when:

- i. the entity's right to receive payment of the dividend is established;
- ii. it is probable that the economic benefits associated with the dividend will flow to the entity; and
- iii. the amount of the dividend can be measured reliably.

Gain (Loss) on investments

Gain/(Loss) on sale of investment 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.

AUDIT PROCEDURE

1. Interest on Fixed Deposits

- Obtain a list of all fixed deposits exist at the beginning of the year and newly made during the audit, along with the applicable interest rate and the number of days for which the deposit was made.
- Verify the arithmetical accuracy of the interest calculation by multiplying the deposit amount with the applicable rate and number of days during the period under audit.
- For deposits outstanding as at the year end, obtain direct confirmation from the respective bank/financial institution.
- 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.
- Obtain a copy of Form 26AS (TDS) and reconcile the interest reflected therein to the calculation shared by client.

2. Dividend

Verify that the dividend is recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established, provided it is probable that the economic benefits associated with the dividend will flow to the entity and the amount of the dividend can be measured reliably.

3. Gain (Loss) on sale of investment in Mutual Funds

- Verify that Gain/(loss) on sale of investment in mutual funds is recognised as other income only on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.
- For this 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.

SALE OF SCRAP

- i. Review the internal control as regards generation, storage and disposal of scrap.
- ii. Check whether the organization is maintaining reasonable record for generation of scrap.
- iii. Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
- iv. Check the rates at which scrap has been sold and compare the rate with previous year.
- v. Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.
- vi. Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.
- vii. Make an overall assessment of the value of realization from scrap as to its reasonableness.



AUDIT OF OTHER EXPENSES (Power & Fuel, Rent, Repairs, Insurance etc.)

COMPOSITION OF OTHER EXPENSES

Other expenses may comprise of following expenses:

- | | |
|--|--|
| (a) Consumption of stores and spare parts; | (e) Repairs to machinery; |
| (b) Power and fuel; | (f) Insurance; |
| (c) Rent; | (g) Rates and taxes, excluding, taxes on income; |
| (d) Repairs to buildings; | (h) Miscellaneous expenses. |

AUDIT PROCEDURE

1. Rent expense

- Obtain a month wise schedule of rent payment along with the rent agreements.
- Examine whether rent expense has been recorded for all 12 months and whether the rent paid is as per the underlying agreement.
- Examine whether agreement contains any escalation clause, if yes, verify whether rent has been increased/adjusted during the period only as per escalation clause.
- Verify whether the agreement is in the name of the entity.
- Verify whether the expense pertains to premises used for running business operations of the entity.

2. Power and fuel expense

- Obtain a month wise expense schedule of payment towards power and fuel along with the power bills.
- Examine whether the expenses have been recorded for all 12 months.
- 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.
- Analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.

3. Insurance expense

- Obtain a summary of insurance policies taken along with their validity period
- Verify whether the expense has been correctly classified between prepaid and expense for the period based on number of days.

4. Legal and professional expenses

- Obtain a month wise and consultant wise summary.
- In case of monthly retainer ship agreements, verify whether the expenditure for all 12 months has been recorded correctly.
- For non-recurring expenses, select a sample on random basis and vouch for the attributes discussed above.
- Special focus should be given 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.

5. Travel, repair and maintenance, printing and stationery, miscellaneous expenses

- Select a sample on random basis and vouch for the occurrence, completeness, measurement and appropriate disclosure.
- Wherever possible, the auditor should try and prepare a summary of expenditure on monthly basis and then analytically compare the trends.
- In addition, auditor should perform analytical procedures to obtain audit evidence as to overall reasonableness of other expense which may include expenditure per unit produced.
- Auditor should analyse expense per unit produced and compare the same with previous years and prevent industry trends and ask for the reasons from Management If any significant variations are found.

6. Foreign travel expenses.

- Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.
- Verify that the tour programme was properly authorised by the competent authority.
- Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.
- See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.
- Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".



AUDIT OF PROVISIONS AND CONTINGENT LIABILITIES

FEATURES OF PROVISIONS AND CONTINGENT LIABILITIES

PROVISION

A provision is a liability which can be measured only by using a substantial degree of estimation.

A provision should be recognised when:

- (a) an enterprise has a present obligation 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 these conditions are not met, no provision should be recognised.

CONTINGENT LIABILITY

A contingent liability is:

- (a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
- (b) a present obligation that arises from past events but is not recognised because:
 - i. it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - ii. a reliable estimate of the amount of the obligation cannot be made.

AUDIT PROCEDURE FOR VERIFICATION

1. Obtain a list of all provisions and compare them with balances in the ledger.
2. Inspect the underlying arrangements like appointment agreement with employees to understand the entity's commitment towards defined benefits, 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. Review minutes of the meetings of the Board of Directors or other similar bodies.
5. Review list of pending law suits and obtain a certificate and opinion of the lawyer dealing with the cases.
6. Review of records relating to contingent liabilities maintained by the company.
7. Review of terms and condition of grants and subsidy availed.
8. Obtain representation from the management that all known contingent liabilities have been included in the accounts and disclosed properly.
9. Ensure that proper disclosure is made of all the contingent liabilities as per the requirements of AS-29 and Schedule III to the Companies Act, 2013.

PROVISION FOR INCOME TAX

- (i) Obtain the computation of income and income tax prepared by the entity and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.
- (ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- (iii) Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.
- (iv) Compute tax payable as per the latest applicable rates in the Finance Act.
- (v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.
- (vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.



AUDIT OF SHARE CAPITAL

AUDIT PROCEDURE IN SPECIAL CASES

1. Issue of Shares at Premium

Where a company has issued shares at a premium, whether for cash or otherwise, company shall transfer the amount received by it to securities premium account and state the means in which the amount in the account can be applied.

As per Sec. 52 of Companies Act, 2013 the securities premium account may be applied by the company for the following purposes:

- issue of unissued shares of the company to the members of the company as fully paid bonus shares;
- writing off the preliminary expenses of the company;
- writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- for the purchase of its own shares or other securities under section 68.

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

2. Issue of Shares at Discount

According to Section 53 of the Companies Act, 2013

- 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.
- Any share issued by a company at a discounted price shall be void.
(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.
- 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.

The auditor needs to check

- The movement in share capital during the year and wherever there is any issue,
- 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.
- 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.

3. Issue of Sweat Equity Shares

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

4. Verification aspects

The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled:

- the issue is authorised by a special resolution passed by the company;
- 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;

AUDIT PROCEDURE

- Compare the year end balances of authorised, issued and paid up share capital, to the previous year audited financial statements.
- If there is no change during the year, obtain a written representation from the management that there were no changes to capital structure during the year.
- If there is any change, obtain the certified copies of relevant resolutions passed at the meetings of board of directors, members authorising the changes in authorised and paid up share capital.
- Obtain a copy of Form SH 7 for increase in authorised share capital. Form PAS 3 for increase in paid up capital and verify the number of securities issued along with the issue price.
- Verify whether the paid-up capital as at the year-end is within the limits of authorised capital.
- In case of increase in authorised share capital, verify whether the Company has accurately calculated the fee and stamp duty payable to MCA and obtain a copy of the receipt in support of the payment made.

- not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business; and
- 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 SEBI 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.

5. Reduction of Capital

The duties of the auditor in this regard are following:

- Verifying that the special resolution has been passed for reduction of capital in the meeting of the shareholder.
- Check that the Articles of Association authorizes the reduction of capital.
- Examine the order of the Tribunal confirming the reduction and ensure that a copy of the order and the minutes have been registered and filed with the ROC.
- Inspecting the ROC Certificate as regards reduction of capital.
- Vouching the journal entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence.
- Ensure that the requirements of Schedule III w.r.t. reduced capital have been complied with.
- Confirming that the revaluation of assets has been properly disclosed in the Balance Sheet.
- Verifying the adjustment made in the members' accounts in the Register of Members and confirming that either the paid-up amount shown on the old share certificates have been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled.
- Confirming 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.
- Verifying that the MOA of the company has been suitably altered.



AUDIT OF RESERVES & SURPLUS (OTHER EQUITY)

MEANING OF RESERVES AND PROVISIONS

Meaning of Reserve

- Reserves are amounts appropriated out of profits which are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist at the date of the Balance Sheet.
- Reserves are made up of amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.

Meaning of Provisions

- Provisions are amounts charged against revenue to provide for depreciation, renewal or diminution in the value of assets or a known liability the amount of which cannot be determined with substantial accuracy or a claim which is disputed.
- Amounts contributed or transferred from profits to make good the diminution in assets values due to the fact that some of them have been lost or destroyed, as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions.
- Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit.

DIFFERENCE BETWEEN RESERVES AND PROVISIONS

Reserves	Provisions
(a) It is an appropriation of profit	(a) It is a charge against Profit.
(b) They are not intended to meet any liability, contingency or diminution in the value of assets, though may be made for some specific purposes, like redemption of debentures.	(b) They are made to provide for depreciation, renewal or a known liability or a disputed claim
(c) Reserves cannot be created unless there is a profit except a few like revaluation reserves	(c) They must be created whether or not there is profit
(d) Reserves are generally optional except few ones like creation of CRR, DRR, etc.	(d) Provisions are not optional and have to be made as per generally accepted accounting principles.

TYPES OF RESERVES

Revenue Reserves

Revenue reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose, e.g., to supplement divisible profits in lean years, to finance an extension of business, to augment the working capital of the business or to generally strengthen the company's financial position.

Capital Reserves

- Capital reserve represents surplus or profit earned in respect of certain types of transactions (like sale of fixed assets at a price in excess of cost, realisation of profits on issue of forfeited shares, etc.) which are not regarded by the directors as free for distribution as a dividend.
- Capital Reserves does not include any amount regarded as free for distribution through the Statement of Profit and Loss.
- Capital reserves includes share premium, capital redemption reserve, development rebate reserve and profit on reissue of forfeited shares.
- Capital reserve, can be utilised for writing down fictitious assets or losses or for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.

AUDIT PROCEDURE

1. Compare the opening balance of reserves and surplus to the previous year audited financial statements.
2. For addition/utilisation in current year, in case of:
 - (a) Profit and Loss balance: Trace the movement as disclosed in Statement of changes in Equity to Surplus/Deficit as per Statement of Profit & Loss for the year under audit. For adjustment related to dividend payment and dividend distribution tax, verify the resolution passed by the board of directors regarding declaration of dividend.
 - (b) Share Premium: Confirm whether company has issued any shares during the year in excess of the nominal value of the shares. Ensure that any withdrawal from securities premium account is in compliance of Sec. 52.
 - (c) Other Equity: Understand the underlying reason for the transaction.



TRADE PAYABLES AND OTHER CURRENT LIABILITIES

COMPLETENESS

(Same as Debtors Cut off Procedure- No Need to Read Before Exam)

The auditor needs to perform the following cut off procedures:

- 1- For the last 5 invoices received/ recorded at the end of the reporting date (cut off 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;
- 2- All goods received prior to the period/ year- end should have been booked in the form of purchases and included in trade creditors.
- 3- 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.
- 4- Match purchase invoice dates to the gate entry (inward) dates to check whether the purchases are being recorded in the correct accounting period. 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.

Advance and Dispute with Customer

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

Statutory Dues Payable Points (Already covered in Advance)

- 8- 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. 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.
- 9- 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.
- 10- 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.
- 11- 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, and 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. Test check the management process to assess if the auditor could rely on the management process.

EXISTENCE

- i. 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.
- ii. Obtain the accounts payable ageing report and trace its balances to the general ledger. If there are any differences, investigate reconciling items. Journal entries specially for large amounts should be carefully examined.

Direct confirmation procedure (SA 505 – No Need to Read Before Exam)

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.
In such cases, the auditor should consider whether there **are valid grounds** for such a request. 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.
5. 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.
6. 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.
7. The **method of selection of the trade creditors** to be circularised **should not be revealed to the Company** until the trial balance of the trade payables' ledger is handed over to the auditor.
8. 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.

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

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.

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

9. 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. The entity should be asked to investigate and reconcile the discrepancies.

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.

10. Where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include: (Imp for Exam)

- 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. (examination in depth)
- D. **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.
- E. **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.



SALE OF PRODUCTS AND SERVICES

Steps to be followed

- Identify the control points over sales.
- Tests the identified controls to determine how strong and reliable they are. If controls are assessed as strong, the auditor can reduce the amount of substantive testing.
- Selects a random sample of transactions and examines the related customer purchase orders, invoices and customer statements.
- Performing substantive audit procedures like vouching and substantive analytical procedure (SAP). SAP will consist of sales trend analysis, comparison of sales figures with previous accounting period etc.
- **Verification of revenue may be carried out by employing the following procedures:**
 - (a) Examination of records;
 - (b) Analytical review procedures.

OCCURRENCE

1. Ensure revenue is not overstated by performing following audit procedures (Imp)

- Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded.
 - Test check few invoices with their relevant entries in sales journal.
 - Obtain confirmation from few customers to ensure genuineness of sales transaction
 - Whether any fictitious customers and sales have been recorded.
 - Whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure
 - Whether unearned revenue recorded as earned.
 - Whether any substantial uncertainty exists about collectability.
 - Whether customer obligations are contingent on other actions (financing, resale, etc.).
- Review sequence of sales invoices
 - Review journal entries for unusual transactions
 - Calculate the ratio of sales return to sales and compare it with previous year and enquire for the reasons for increase/ decrease.
 - Check the sales return with sales invoice, challan, credit note, stock register, etc.

COMPLETENESS

- Cut-off errors will usually arise when companies recognize 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. 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.
- Auditors should also verify the credit notes issued after the accounting period. 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.
- Trace from the shipping documents to the sales journal.
- 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.
- 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

- Trace a few transactions from inception to completion. (Examination in depth)

E.g: 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.

- if the client is engaged in export sales, then compliance with AS 11 shall be ensured.
- Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.
- 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.