CA INTERMEDIATE

AUDITING AND ETHICS

Part 02

- ICAI Study Material Questions Covered
- RTP/MTP Questions Covered
- Previous Year Questions Covered

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CA INTERMEDIATE

AUDITING & ETHICS

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Other Expenses like Power and Fuel, Rent, Repair to Building, Plant and Machinery, Insurance, Travelling, Legal and Professional, Miscellaneous Expenses.

Notes to Add

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. Both depreciation and amortization are methods that are used to prorate the cost of a specific type of asset over its useful life. 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.

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:

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.
- The accounting policy has been applied consistently year on year. Any change in the accounting policy has been adequately disclosed.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- 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.
- Example: It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.
- 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:

Brief description	Audit procedures
Depreciation and amortization expenses pertaining to the period have been recorded appropriately and there in no understatement/ overstatement Depreciation and amortization expenses have been measured appropriately. Recorded depreciation and amortization expenses were actually incurred during the period	❑ Obtain an understanding of entity's process of charging depreciation and amortization. ❑ Obtain the fixed asset register maintained by the entity. 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. 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. Obtain a list of all additions/ deletions along with their proper approval from the authorised person for the same. ○ Select the sample of assets from the Fixed Assets Register, on materiality considerations and verify the rates of depreciation and depreciation calculations. ❑ Obtain the list of all the components identified by the management. Ensure Intangible assets like patents, goodwill, copy rights have been properly amortized over the period. ❑ Ensure Intangible assets like patents, goodwill, copy rights have been properly amortized over the period.
	❑ 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. ❑ Ensure depreciation on revalued amount has been properly accounted from revaluation reserve. ❑ 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.

	- 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. For example- Re-compute the depreciation expense for the year. - Ensure that the depreciation and amortization has been charged as per the useful lives of PPE and intangible assets. - Ensure that residual values have been properly verified as that impacts the computation of depreciation. - Ensure that the depreciation and amortization has been computed prospectively whenever there is any change in useful lives of PPE and intangible assets.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

23. Tangible assets are depreciated when the asset is actually put to active use.

Ans. Incorrect: Depreciation is a fall in value of asset due to obsolescence, usage and effluxion of time, Therefore, depreciation is charged when the asset is ready for use . Active use of asset is not a mandatory criteria for charge of depreciation.

Notes to Add

OTHER EXPENSES LIKE POWER AND FUEL, RENT, REPAIR TO BUILDING, PLANT AND MACHINERY, INSURANCE, TRAVELLING, LEGAL AND PROFESSIONAL, MISCELLANEOUS EXPENSES

*** Rent Expense**

(i) Month wise schedule + Rent Agreement

(ii) Recorded → For all 12 months

(iii) Escalation Clause

(iv) Agreement → Name of the Entity

*** Power & Fuel Expense**

(i) Month wise schedule + Power Bills

(ii) Recorded → For all 12 months

(iii) Summary → Power units Consumed
→ Applicable Rate

+

Arithmetical Accuracy

(iv) Monthly Trends

Notes to Add

Notes to Add

OTHER EXPENSES

*** Insurance Expense**

(i) Summary of Policies

(ii) Validity pd.

(iii) Classification → Prepaid / C.Y → Correct?

*** Legal & Professional Expense**

(i) Month / Consultant → Wise → Summary

(ii) Monthly Retainership Agreement

+

12 month Expenditure → Recorded Correctly

(iii) Sample → Non-recurring exp.

(iv) May highlight → dispute → Entity

- **Not made any Provision**
- **Not have been discussed to Auditor**

*** Travel, Repair & Maintenance, Printing & Stationery, Misc. Exp.**

(i) Sample Basis

(ii) Monthly Summary

(iii) Perform Analytical Procedure

(iv) Compare — [P.Y / Present Industry] — trends + Significant Variation

Additional Info.

(1) C.S.R. → Sec. 135 → Disclose → Amount

- **Required to be disclosed**
- **Expenditure Incurred**
- **Shortfall at the end**
- **P.Y. Shortfall**
- **Reason for Shortfall**

(2) Details of — [Crypto / Virtual] — Currency

Disclose

- Profit / (loss) ↓ On transactions
- Amount of Currency ↓ @ Reporting Date
- Deposit
- Advance
  - (Deposit / Advance) From Any person
    - Trading
    - Investing

An entity in addition to making purchases and incurring employee benefit expenses, also incurs other expenditures 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:

- Whether the expenditure pertained to current period under audit;
- Whether the expenditure qualified as a revenue and not capital expenditure;
- Whether the expenditure had a valid supporting documents like travel tickets, insurance policy, third party invoice etc.;
- Whether the expenditure has been classified under the correct expense head;
- Whether the expenditure was authorised as per the delegation of authority matrix;
- 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:

Brief description	Audit procedures
Recorded other expenses were actually incurred during the period Other expenses pertaining to the period have been recorded appropriately and there in no understatement or overstatement Other expenses have been measured appropriately	**Rent expense** ❑ Obtain a month wise expense schedule along with the rent agreements. ❑ Verify if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement. ❑ 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. ❑ 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 ❑ Obtain a month wise expense schedule along with the power bills. ❑ Verify if expense has been recorded for all 12 months. ❑ 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. ❑ 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 ❑ 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. **Legal and professional expenses** ❑ Obtain a month-wise and consultant-wise summary. ❑ In case of monthly retainership agreements, verify whether the expenditure for all 12 months has been recorded correctly. ❑ For non-recurring expenses, select a sample and vouch for the attributes discussed above. ❑ 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 – ❑ The auditor should select a sample and vouch for the attributes discussed above. Wherever possible, the auditor should try to prepare a summary of expenditure on monthly basis and then analytically compare the trends. ❑ Perform analytical procedures to obtain audit evidence as to overall reasonableness of other expense which may include expenditure per unit of production analysis. ❑ Auditor should analyse expense per unit produced and compare the same with previous years and present industry trends and ask for the reasons from the management, if any significant variations are found.
Required **DISCLOSURE** for other expenses have been appropriately made	❑ Ensure other expense have been classified ❑ under: ❑ Rent. ❑ Insurance. ❑ Power and fuel. ❑ Repairs and maintenance- Building, Plant and machinery, others. ❑ Legal and professional. ❑ Printing and stationary. ❑ Travel expenses. ❑ Miscellaneous expenses.

NOTES

To be disclosed as Additional Information

(1) Corporate Social Responsibility (CSR) (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.

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.

QUESTIONS

Theory Questions

24. B Ltd. is covered u/s 135 of the Companies Act, 2013 i.e. Corporate Social Responsibility (CSR). What matters (other than the amount spent, amount not spent, amount required to be spent etc.) shall be disclosed by the company with regard to CSR activities done by the company?

Ans. Corporate Social Responsibility (CSR): Since B Ltd is covered under section 135 of the Companies Act, the following matters shall be disclosed by the B Ltd with regard to CSR activities:

(*a*) total of previous years shortfall,

(*b*) reason for shortfall,

(*c*) nature of CSR activities,

(*d*) 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,

(*e*) 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.

Test Your Understanding 3

Various ratios of current year and preceding year are disclosed in financial statements of a company in accordance with requirements of Schedule III of Companies Act, 2013. Discuss requirements of law in this regard (Do not list out names of ratios)

Ans. A company has to disclose various ratios in its financial statements in accordance with requirements of Schedule III of Companies Act, 2013. The company shall also explain the terms 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.

An auditor of a company is focusing upon revenues of a company. In this regard, besides performing usual detailed checking of sales, he wants to perform substantive analytical procedures in respect of sales. Discuss how he can perform such procedures.

Ans. Substantive analytical procedures in respect of sales 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 comparing that with the client's sales records. 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.

While verifying depreciation charged to statement of profit and loss account of a company, it is noticed by auditor that one new machinery was purchased and installed in month of April. The necessary trials were carried out and machinery was ready for use in April itself. However, owing to lack of orders in the market, the said machinery was put into actual operation from 1st October. The company has, accordingly, provided depreciation in its books on this machinery w.e.f. 1st October. Is above recording of deprecation by company proper in its books?

Ans. 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. Depreciation on asset is charged on asset from the date when it is ready for use and not from date of actual usage.

Hence, recording of depreciation by company w.e.f. 1st October is not proper.

Theory Questions

25. A Ltd. has traded for 50.00 Lacs in "TETRA", a virtual currency, during the F.Y. 2021 -2022 and earned a profit of 20.00 Lacs on it. What disclosure requirements are prescribed for such type of transactions done by the company?

Ans. Disclosure 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.

CASE STUDY

Sunsteel Ltd. is a company engaged in the manufacture of variety of stainless steel household items ranging from hot pot, pressure cooker, cutlery set, bottles, to serving trays. The company has its corporate office in Delhi and its plant in Raigarh, a city in the state of Chhattisgarh. The company is planning to expand its manufacturing activities by setting up two new plants in the Raipur district of the state. For this purpose, the company also raised funds by making a follow-on public offer during the financial year 2022-23. R K Maheshwari & Associates are the statutory auditors of the company since the year 2020 -21. The engagement team consisted of 5 members, with CA Raman as the engagement partner, CA Madhu as the senior associate and three articled trainees namely, Aman, Chetanya and Depesh.

The company raised fresh capital of ₹ 5 Cr during the FY 2022-23. The shares with the nominal value of ₹ 10 per share were issued at a premium of ₹ 5 per share.

During the course of audit, CA Raman, Chetanya and Depesh also visited the power plants in Raigarh to get a detailed understanding of the manufacturing process. The team performed analytical procedures to obtain audit evidence with respect to the overall reasonableness of purchase quantity and price of inventory. More specifically, Chetanya collected the reports from the management for composition of stock i.e. raw materials as a percentage of total stock and compared the same with the data of the previous year. CA Raman and Chetanya thereafter, discussed the reasons for the variations with the management.

Also, while considering the presentation and disclosure requirements as per Schedule III to the Companies Act, CA Madhu discussed with CA Raman the disclosure with respect to the following account balances:

- Current maturities to long term borrowings
- Long term maturities of finance lease obligations
- Interest accrued but not due on borrowings
- Interest accrued and due on borrowings

Based on the above facts, answer the following questions:

26. Which of the following is not correct with respect to shares issued at premium and securities premium account in terms of Section 52 of the Companies Act, 2013?

(*a*) Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a securities premium account.

(*b*) The securities premium account can be applied by the company in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares.

(*c*) The securities premium account cannot be applied by the company in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company.

(*d*) The securities premium account can be applied by the company for the purchase of its own shares or securities under section 68.

Ans. (*c*)

27. Which of the following is not an example of capital reserve?

(*a*) Revaluation reserve arising from revaluation of fixed assets

(*b*) Securities Premium

(*c*) Capital redemption reserve

(*d*) General reserve

Ans. (*d*)

28. **Statement 1:** Confirmations as well as undelivered letters should be given/ returned to the auditor and not to the client.

Statement 2: When no reply is received, the auditor should perform alternate procedures regarding the balances.

(*a*) Only statement 1 is correct
(*b*) Only statement 2 is correct
(*c*) Both statements 1 & 2 are correct
(*d*) Both statements 1 & 2 are incorrect

Ans. (*c*)

29. Mr. Chetanya performed which of the following analytical procedures to obtain the audit evidence with respect to the overall reasonableness of purchase quantity and price of raw material?

(*a*) Consumption Analysis (*b*) Stock Composition Analysis
(*c*) Reasonableness test (*d*) Ratio analysis

Ans. (*b*)

30. Which of the following is not correct with respect to the disclosure requirements of Schedule III to the Companies Act 2013?

(*a*) Current maturities of long term borrowings is to be disclosed under the head long term borrowings
(*b*) Long term maturities of finance lease obligations is to be disclosed under the head long term borrowings
(*c*) Interest accrued but not due on borrowings is to be disclosed under the head Other Current Liabilities
(*d*) Interest accrued and due on borrowings is to be disclosed under the head Other Current Liabilities

Ans. (*a*)

IMPORTANT NOTE

Students are advised to refer Accounting Study Material (Paper-1 & 5 both) wherever reference to Accounting Standards is given and also to Corporate and Other Law Study Material (Paper-2) wherever reference to Sections of Companies Act, 2013 is given.

EXTRA QUESTIONS

Theory Questions

31. M/s SS & Associates have been appointed as statutory auditors of Green Limited, a company engaged in the business of manufacturing of hardware products. They are analyzing the monthly trends for other expenses like rent, power and fuel, repairs, etc. and are also verifying attributes of such types of expenses. List down the attributes for verifying such expenses.

Ans. Attributes for verifying other expenses like Power and Fuel, Repair etc.: An entity in addition to making purchases and incurring employee benefit expenses, also incurs other expenditures 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 document 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.

32. Proft and Loss account of an organization shows various types of expenses like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations. What are the attributes that an auditor generally prefers for vouching these types of expenses?

Ans. Attributes to be preferred for vouching other expenses: 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:
(*i*) Whether the expenditure pertained to current period under audit;
(*ii*) Whether the expenditure qualified as a revenue and not capital expenditure;
(*iii*) Whether the expenditure had a valid supporting documents like travel tickets, insurance policy, third party invoice etc.;
(*iv*) Whether the expenditure has been classified under the correct expense head;
(*v*) Whether the expenditure was authorised as per the delegation of authority matrix;
(*vi*) Whether the expenditure was in relation to the entity's business and not a personal expenditure.

33. How will you vouch and/or verify the following:
(*a*) Goods sent out on Sale or Return Basis.
(*b*) Borrowing from Banks.

Ans. (a) Goods Sent Out on Sale or Return Basis:
(*i*) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
(*ii*) Verify that price of such goods is unloaded from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.
(*iii*) Ensure that the goods in respect of which the period of approval has expired at the end of the year, have either been received back or customers' accounts have been debited.
(*iv*) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory.

(b) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows-
(*i*) Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(*s*) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.

(*ii*) Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.

(*iii*) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

(*iv*) Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.

Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

34. How will you vouch/verify the following: (ICAI Study Material)

(*a*) Goods sent on consignment. (*b*) Foreign travel expenses.

(*c*) Receipt of capital subsidy. (*d*) Provision for income tax.

Ans.

(*a*) Goods Sent on Consignment:

(*i*) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.

(*ii*) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.

(*iii*) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date.

Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.

(*iv*) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value.

Also see that the allowance has been made for damaged and obsolete goods in making the valuation.

(*v*) See that goods in hand with the consignee have been shown separately under the head inventories.

(*b*) Foreign Travel Expenses:

(*i*) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.

(*ii*) Verify that the tour programme was properly authorised by the competent authority.

(*iii*) 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.

(*iv*) 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.

(*v*) 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"

(*c*) Receipt of Capital Subsidy:

(*i*) Check the application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

(*ii*) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

(*iii*) Ensure that the conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.

(*iv*) Check relevant entries for receipt of subsidy.

(*v*) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

(*d*) 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.

35. How will you vouch and/or verify payment of taxes?

Ans. Vouching of Payment of Taxes:

(*i*) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.

(*ii*) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.

(*iii*) The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.

(*iv*) Nowadays, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.

(*v*) The entity can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. This should be checked by the auditor.

(*vi*) It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching such e-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No/TAN No. etc.

36. How would you vouch/verify the following:

(*a*) Advertisement Expenses.

(*b*) Sale of Scrap.

Ans. (*a*) Advertisement Expenses:

(*i*) Verify the bills/invoices from advertising agency to ensure that rates charged for different types of advertisement are as per the contract.

(*ii*) See that the advertisement relates to client's business. Inspect the receipt issued by the agency.

(*iii*) Ascertain the nature of expenditure – revenue or capital expenditure and see that it has been recorded properly.

(*iv*) Ascertain the perio for which payment is made and see that prepaid amount, if any, is carried to the balance sheet.

(*v*) See that all outstanding advertisement bills have been provided for.

(*b*) 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.

❑❑❑

6

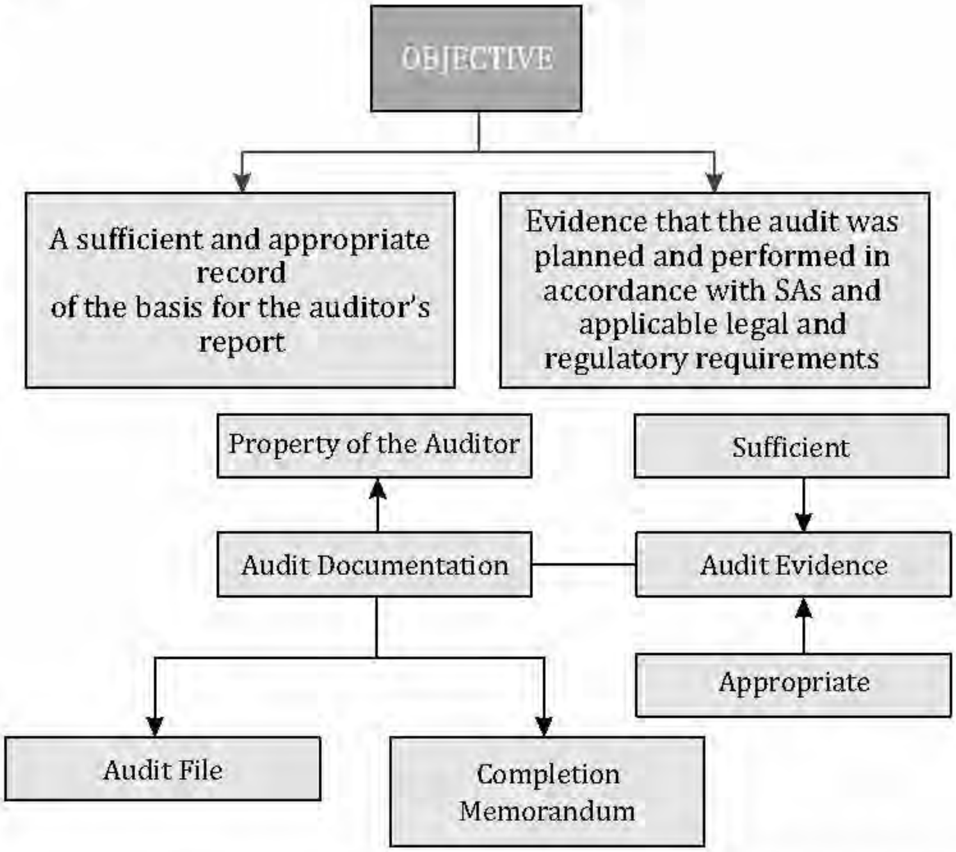
CHAPTER

Audit Documentation

S. No.	Sub Topics	Easy	Moderate	Hard
01.	Definition of Audit Documentation			
02.	Objective of the Auditor			
03.	Nature of Audit Documentation			
04.	Purpose of Audit Documentation			
05.	Form, Content and Extent of Audit Documentation			
06.	Examples of Audit Documentation			
07.	Timely Preparation of Audit Documentation			
08.	Audit File			
09.	Assembly of the Final Audit File			
10.	Documentation of Significant Matters and Related Significant Professional Judgments			
11.	Completion Memorandum or Audit Documentation Summary			
12.	Ownership of Audit Documentation			

Notes to Add

OVERVIEW



Notes to Add

Sameer received a news alert on his mobile pointing to unconfirmed media reports of providing a Digi locker type facility to auditors for keeping audit documentation in times to come. He immediately grasped the idea as Aadhar card, senior secondary school mark sheet and driving license were being stored by him in such an electronic locker. "Such a facility, if it happened to materialize in future in whatever form, would provide many benefits which come with such an electronic storage", he pondered.

Audit evidence which an auditor obtains by performing various audit procedures along with details of those procedures have to be put into writing. Further, inferences drawn upon by the auditor from evidence obtained and conclusions reached are also documented. Sameer was spontaneously nodding that auditing was, indeed, a logical process.

Without proper documentation, an audit has no legs to stand upon. It is audit documentation which serves as a record of audit work performed. He was also mulling over that, in fact, audit documentation throws up a sort of protective shield around auditors. If an auditor plans and performs his work professionally, his working papers will come to his rescue, in case such a situation arises. Conclusions reached by him can be traced to his working papers.

"Oh! That is importance of documentation", he exclaimed. Now, he understood why Shekhar's seniors used to prompt him to make correspondence with company's officers on mail. Because, it is the documentation that makes the difference. They were right because consequences of not making proper documentation were known to them and poor guys like us were still on learning curve.

Notes to Add

AUDIT DOCUMENTATION

SA-230 → Auditor's Responsibility → Audit of

- **F.S** ↓ **To Prepare**
- **Other Historical Fin. Info.** ↓ **To be adapted → As Necessary**

→ Documentation Requirement

- **Other SAs** ↓ **Do Not Limit the Application** ↓ **of SA 230**
- **Laws / Regulation** ↓ **May establish → Additional** Req.

DEFINITION OF AUDIT DOCUMENTATION

Audit Documentation – SA 230
(Working Papers)
↓
Record of

- Audit Procedures Performed
- Relevant A.E. Obtained
- Conclusion of Auditor

Record of audit procedures preformed
↓
Relevant audit evidence obtained
↓
Conclusion the auditor reached

OBJECTIVE OF THE AUDITOR

Prepare Documentation → That provides

Suff. + Appro.
↓
RECORD
↓
Of the basis for → Audit Report

Evidence
↓
Audit

- Planned
- Performed

Acc. With SAs

SA 230 on "Audit Documentation", deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. It is to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The specific documentation requirements of other SAs do not limit the application of this SA. Laws or regulations may establish additional documentation requirements.

Notes to Add

Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)

Notes to Add

The objective of the auditor is to prepare documentation that provides:

(a) A sufficient and appropriate record of the basis for the auditor's report; and

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

- To prepare documentation that provides:

  (a) A sufficient and appropriate record of the basis for the auditor's report; and

  (b) Evidence that the audit was planned and performed in accordance with SAs.

NATURE OF AUDIT DOCUMENTATION

Audit documentation provides:

Nature of Audit Doument → Provides (A.E)

- Auditor's basis for a conclusion about the achievement of overall objectives of Auditor
- Audit – was – Planned / Performed
  - As per
    - SA
    - Legal Requirements
    - Regulatory

PURPOSE OF AUDIT DOCUMENTATION

(i) **Assisting → Engagement Team to – Plan / Perform – An audit**

(ii) **Assisting → Member of Audit Team to – D / R / S**

(iii) **Making Engagement Team → Accountable for their work**

(iv) **Retaining a Record → Of continuing Significance**

(v) **Enable to Conduct of → Q.C – Revieus / Inspections**

(vi) **Enabling the conduct of → External Inspection → In accordance with applicable**

- **Legal**
- **Regulatory**
- **Other**

→ **Requirements**

Notes to Add

(a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and

(b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Notes to Add

The following are the purpose of Audit documentation:

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
3. Enabling the engagement team to be accountable for its work.
4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Illustration 1: A new team member of the auditors of Extremely Vibrant Limited was of the view that Audit Documentation does not help in planning the audit of any company. Explain whether Audit Documentation has any relation with regard to planning the audit of a company.

Solution: Audit Documentation helps in planning the audit of a company in a proper manner and also helps in conducting the audit of that company in a more effective way.

Notes to Add

FORM, CONTENT AND EXTENT OF AUDIT DOCUMENTATION

→ Auditor → Prepares → Audit Documentation

↓

Reasons

↓

To Understand

- N.E.T
  - ↓ Audit Procedures
- Result
  - Audit Procedures
  - A.E. Obtained
- Significant
  - Matters + Conclusions
  - Prof. Judgement

Form, Extent & Content of Audit Document
Depends on:

(i) Size & Complexity of Entity.

(ii) Nature of Audit Procedure to be performed

(iii) Identified RoMM

(iv) Significance of A.E. Obtained

(v) The N.E of identified Exception

(vi) Need / Basis for conclusion → not readily determinable from

- Document
- Work Performed
- A.E Obtained

(vii) The Audit Methodology & Tools Used

Notes to Add

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

(*a*) The nature, timing and extent of the audit procedures performed.

(*b*) The results of the auditprocedures performed and the audit evidence obtained and

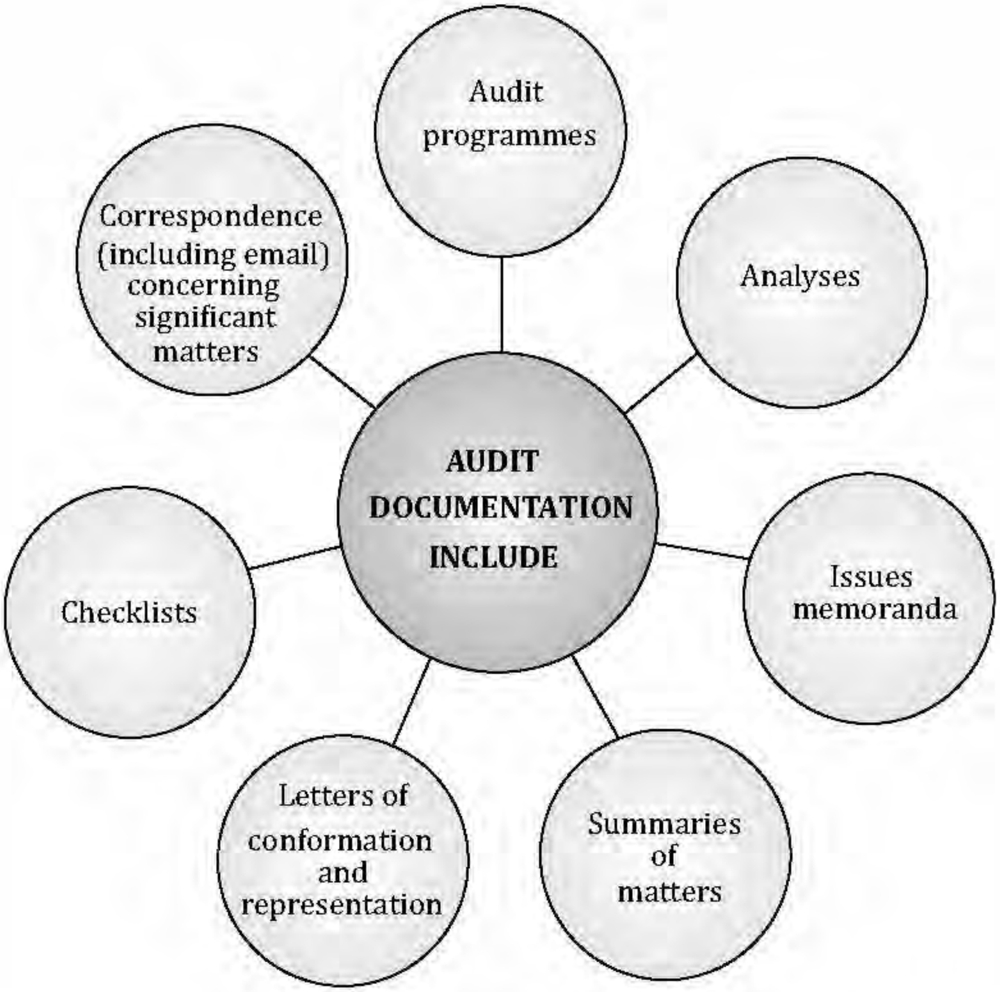
(*c*) Significant matters arising during the audit and the conclusions reached thereon and significant professional judgements made in reaching those conclusions.

- Further in documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
  (a) The identifying characteristics of the specific items or matters tested.
  (b) Who performed the audit work and the date such work was completed; and
  (c) Who reviewed the audit work performed and the date and extent of such review.
- The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.
- If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency

The form, content and extent of audit documentation depend on factors such as:

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

Notes to Add


Audit programmes
Correspondence (including email) concerning significant matters
Analyses
AUDIT DOCUMENTATION INCLUDE
Checklists
Issues memoranda
Letters of conformation and representation
Summaries of matters

Notes to Add

EXAMPLES OF AUDIT DOCUMENTATION

Audit Document indudes

(i) Audit Programs.
(ii) Analysis
(iii) Issued Memoranda (Plural of Memorandum)
(iv) Summaries of Significant matters
(v) Letter of Confirmation & Representation
(vi) Correspondence Concerning significant matters
→ Can make copies of entity's records (like contracts, etc.)
→ Not a substitute for entity's A/c Records

Audit documentation may be recorded on paper or on electronic or other media.

Example

- Audit Documentation include:
- Audit programmes.
- Analyses.
- Issues memoranda.
- Summaries of significant matters.
- Letters of confirmation and representation. Checklists.
- Correspondence (including e-mail) concerning significant matters.

The auditor may include copies of the entity's records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation is not a substitute for the entity's accounting records.

The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

Notes to Add

TIMELY PREPARATION OF AUDIT DOCUMENTATION

- Enhances
  ↓
  Quality of Audit
- Facilitates
  - Effective
    ↓
    Review
  - Evaluation
    - A.E
    - Conclusions

Documentation Prepared → AFTER → Audit work is performed
↓
Less ACCURATE

AUDIT FILE

- Storage Media
- Physical or electronic form
- Containing records of Audit Document → Specific Engagement

Notes to Add

The auditor shall prepare audit documentation on a timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalised. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

Notes to Add

Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

- one or more folders or other storage media
- in physical or electronic form, containing the record that comprise
- the audit documentation for a specific engagement

Illustration 2: While auditing the books of accounts of Very Careful Limited for the financial year 2020-21, a team member of the auditors of Very Careful Limited was of the view that with regard to audit of the company, no relation exists between Audit File and Audit Documentation. Explain the relationship between Audit File and Audit Documentation.

Solution: Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

Notes to Add

ASSEMBLY OF FINAL AUDIT FILE

- Is an administrative process
- to be completed on Timely Manner
- After the date of Auditor's Report

SQC 1 "Quality control for firms that perform Audit & Reviews of Historical Financial Info and other Assurance & Related Sowices"

↓

Requires Firms to Establish → P & P

For Timely completion of Assembly of Audit File

Generally 60 days within & after the Audit Report)

Assembly of Audit file ≠ New Audit Procedure

≠ Drawing New conclusion

Δ May be made → At final stage of Assembly → If they are → Administrative in Nature

Example of Δs

(1) Deleting / Discarding → Superseded Document

(2) Sorting / Collating & Cross Referencing → Working Papers

(3) Signing off on → Completion check - list

(4) Documenting A.E. → That auditor has obtained, discussed & Agreed with Relevant members of Engagement Team Before the date of Auditor's Report.

- Auditor shall Not → Delete/Discard → any Nature of Audit Document Till Its Retention Period → As per SQC 1 → Generally 7 Years / Group Auditors Report

Notes to Add

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

- SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.
- An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.
- Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.
- After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.
- SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.
- Judging the significance of a matter requires an objective analysis of the facts and circumstances.

Notes to Add

DOCUMENTATION OF SIGNIFICANT MATTERS AND RELATED SIGNIFICANT PROFESSIONAL JUDGEMENTS

Eg. of Significant Matters

(1) Matters that give rise to significant Risk

(2) Result of Audit procedures indicating

- F.S. could be MM
- Need to Revise previous RoMM & Auditor's Response to those Risk
- Circumstances that cause the Auditor Significant Difficulty in Applying necessary procedures.
- Finding that could result in a modification of Audit Report

Factors determining N.E.T of Audit Document of Significant Matters

↓

Extent of Professional Judgement Exercised

Performing the work | **Evaluating the Result**

*** Documentation → Sig. Matters**

↓

Explains ↓ **Auditor's Conclusions**

Reinforces ↓ **Quality of Judgement**

* Interest to those → who are

Reviewing Audit Documentation

Carrying Subsequent Audits

Reviewing Matters of ↓ Contd. Significance

TO CHECK

↓

Rationale / Basis

↓

Auditors Conclusion

Notes to Add

Examples of significant matters include:

Matters that give rise to significant risks.

- Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgement exercised in performing the work and evaluating the results.

Documentation of the professional judgements made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgement.

Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgement include, where the matters and judgements are significant:

The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.

The basis for the auditor's conclusion on the reasonableness of areas of subjective judgements (for example, the reasonableness of significant accounting estimates).

The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

Notes to Add

COMPLETION MEMORANDUM OR AUDIT DOCUMENTATION SUMMARY

It is helpful to → Consider → Retain → CM → That Discribes

Significant Matters Identified during the Audit (SA 315)

How they were Addressed? (SA 330)

Benefits of CM

(i) Eff. & Eff. → Review → Inspection → of Audit Document

(ii) Assist Auditors consideration of Significant Matters

(iii) Any Devience from SA

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

- the significant matters identified during the audit and
- how they were addressed.

OWNERSHIP OF AUDIT DOCUMENTATION

→ As per SQC 1 : Unless otherwise Prescribed → the property of Auditor

Law

Regulation

He May Provide → Portions → Extracts → of Audit Document → To Clients

Provided → Does not undermine the

Validity of work performed ↓ Incase of Audit Engagement

Independence of Auditor / Audit Team ↓ Incase of Assurance Engagement

Notes to Add

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Notes to Add

- Standard on Quality Control (SQC) 1 provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor.
- He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.
  - Standard on Quality Control (SQC) 1 provides that audit documentation is the property of the auditor.
  - He may make portions of, or extracts from, audit documentation available to clients subject to some conditions.

Illustration 3: A director of Very Different Limited was of the view that Audit Documentation of a company is the property of that company. Comment on the contention of the director regarding the audit documentation of the company.

Solution: Audit Documentation of a company is not the property of the company rather Audit Documentation is the property of Auditor of that company.

Notes to Add

Test Your Understanding

1. During the course of audit of a company, an issue arose relating to treatment of interest costs of company on its restructured loans taken from a bank. This important matter was discussed with CFO of the company and was properly resolved. Is it necessary for the auditor to include in its working papers?

Ans. The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

In the instant case, an important matter regarding treatment of interest costs of company on its restructured loans taken from a bank directly impacting profits of the company was discussed. Although issue was resolved, it is necessary to document the same by including detail of the person with whom discussions took place along with date.

2. CA Sonali Morarka has completed audit of a listed company. The audit report dated 15th July, 2022 has been issued. However, audit working papers including record of discussions with management, details of audit procedures performed to obtain audit evidence and conclusions reached by her have not been properly assembled. More than six months have elapsed after issue of audit report. Subsequently, she has received a letter from regulator in connection with audit of the company requesting her to share copy of audit file.

The letter has woken up her from deep slumber. She hurriedly assembled audit file and inserted some more papers which were necessary. However, she put current date on these inserted papers and the copy of audit file was sent to regulator. Discuss, the issues involved, in context of "audit documentation".

Ans. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

Further, preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

In the given case, even after passage of more than six months, she has not assembled audit file. Besides, she has put in some papers with current date which is not permissible at all. It shows that part of audit documentation has been prepared afterwards putting a question mark on quality of audit.

CASE STUDY

CA Rajan Pillai is heading the engagement team conducting audit of a company. While audit is in progress, consider following issues regarding audit documentation:-

(A) Audit programme was prepared assigning responsibilities for different types of works to be performed to team members. The engagement team consists of 4 members Mohit (CA final student), Rohit (CA final student), Shobhit (Paid CA) and CA Rajan Pillai (partner of audit firm).

(B) The team has determined materiality for financial statements as a whole.

(C) The team has assessed risks of material misstatements to be low.

(D) CA Shobhit is responsible for attending inventory count process and putting down its documentation part.

(E) During the course of audit, many related party transactions have come to notice.

QUESTIONS

On the basis of above, Answer the Following Questions

1. Work relating to verification of revenue was assigned to Mohit in audit programme. However, it is being performed by Rohit actually. Verification of trade receivables was planned to be carried out by Rohit in audit programme. However, it being performed by CA Rajan Pillai due to last minute practical issues. Which of the following statements is most appropriate in this regard relating to audit documentation?
   (*a*) Audit programme contains names of persons and work to be performed. It is immaterial whether work assigned to one person is performed by another person.
   (*b*) Audit programme was already prepared. Only persons assigned specific responsibilities can perform those duties.
   (*c*) It is necessary that audit programme be suitably updated or notes are given in working papers to this effect so that planned duties are in accordance with actual work performance.
   (*d*) Changes in audit programme or notes clarifying the matter are required only when a person not forming part of engagement team is deputed to perform a duty. Otherwise, this issue of inter-shuffling of team members is frivolous.

Ans. (*c*)

2. As regards materiality, which of the following statements is most appropriate in context of audit documentation?
   (*a*) Materiality has already been determined. There is no need to put it into working papers.
   (*b*) Materiality depends upon professional judgment of auditor. Whatever amount has been determined can be documented in working papers.
   (*c*) Materiality arrived on basis of professional judgment along with factors considered in the determination has to be documented.
   (*d*) Materiality has been arrived upon professional judgment. It also depends upon professional judgment of auditor whether he wants to document it or not.

Ans. (*c*)

3. As regards team's assessment that risk of material misstatements is low, which of the following statements is odd one relating to documentation of risk?
   (*a*) Discussion amongst engagement team members and detail of significant decisions reached has to be documented.
   (*b*) Details of risk assessment procedures have to be documented.
   (*c*) Details about how understanding of each component of internal control was obtained has to be documented.
   (*d*) Precise calculation of risk of material misstatements has to be documented.

Ans. (*d*)

4. CA Shobhit is responsible for attending physical inventory count of the company. Which of the following is not true in this regard relating to audit documentation?
   (*a*) Dates on which physical inventory count process was attended by him should be documented. It may also include photographs of that date showing his attendance of inventory counting process at a particular location.
   (*b*) Detail of test counting undertaken should form part of audit documentation.
   (*c*) Detail of obsolete goods found should form part of audit documentation.
   (*d*) Reports showing that stocks conform to quality control standards in accordance with law are essential part of audit documentation.

Ans. (*d*)

5. As regards related party transactions, which of the following should not be part of audit documentation?
   (*a*) Management representation letter in this regard
   (*b*) Related party transaction policy of the company
   (*c*) Documentation to show that such transactions are at arm's length basis
   (*d*) Documentation to show that such transactions are at close length basis.

Ans. (*d*)

Multiple Choice Questions (MCQ)

Test Your Knowledge

1. Which of the following statement is appropriately suited to preparation of audit documentation?
   (*a*) Audit documentation has to be prepared simultaneously as audit progresses
   (*b*) Audit documentation has to be prepared 60 days after date of audit report
   (*c*) Audit documentation has to be prepared when information is required by regulator
   (*d*) Audit documentation has to be prepared 60 days after completion of audit work

Ans. (*a*)

2. Audit documentation is owned by: -
   (*a*) Client
   (*b*) Auditor
   (*c*) Team member responsible for documentation
   (*d*) Regulator

Ans. (*b*)

3. Which of the following is least likely to be included in audit documentation of a company engaged in manufacturing and export of goods?
   (*a*) Previous years audited financial statements
   (*b*) Projected cash flow statement for next twelve months provided by management in support of going concern assumption
   (*c*) Statements showing dispatch of overseas consignments in accordance with delivery schedules of overseas buyers
   (*d*) Statement showing verification of ageing of trade receivables as on date of balance sheet

Ans. (*c*)

4. Which of the following is false in relation to audit documentation when an external auditor relies upon work of internal auditor?
   (*a*) Evaluation of objectivity and competence of internal auditor has to be documented
   (*b*) Nature of work used and reason for relying upon work used forms part of documentation
   (*c*) Documentation on whether quality control is exercised in internal audit work forms part of audit documentation
   (*d*) Documentation on what specific recommendations were given by internal auditor for risk assessment to external auditor forms part of audit documentation

Ans. (*d*)

Correct /Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

6. As per SA 230 on "Audit Documentation", the working papers are not the property of the auditor.

Ans. (Incorrect)

As per SA 230 on "Audit Documentation" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

7. Mr. A is a statutory auditor of ABC Ltd. The branch of ABC Ltd. is audited by Mr. B, another Chartered Accountant. Mr. A requests for the photocopies of the audit documentation of Mr. B pertaining to the branch audit.

Ans. (Incorrect)

SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

8. The form, content and extent of audit documentation depends upon number of factors. List out any four such factors.

Ans. Refer to heading "Form, content and extent of audit documentation"

9. Discuss any two purposes of audit documentation.

Ans. Refer to heading "Purpose of audit documentation"

10. Define audit documentation. Also give some examples.

Ans. Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)

Refer Heading – Examples of Audit Documentation

11. "Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits". Explain.

Ans. Refer Heading – Completion Memorandum or Audit Documentation Summary

❑❑❑

CHAPTER 7

Completion & Review

S. No.	Sub Topics	Easy	Moderate	Hard
01.	SA 560 Subsequent Events			
02.	Objectives of auditor in accordance with SA 560			
03.	Audit procedures relating to events occurring between the date of the financial statements and the date of the auditor's report			
04.	Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued			
05.	Facts which become known to the auditor after the financial Statements Have been issued			
06.	SA 570 Going Concern			
07.	Responsibility for assessment of the entity's ability to continue as a going concern			
08.	Responsibilities of the auditor			
09.	Objectives of auditor in accordance with SA 570			
10.	Risk assessment procedures and related activities			
11.	Evaluating management's assessment			
12.	Additional audit procedures when events or conditions are identified			
13.	Auditor's conclusions			
14.	Adequacy of disclosures when events or conditions have been identified and a material uncertainty exists			
15.	Adequacy of disclosures when events or conditions have been identified but no material uncertainty exists			
16.	Implications for the auditor's report			
17.	Evaluation of misstatements identified during the audit			
18.	SA 450 Evaluation of Misstatements Identified during the Audit			
19.	Objectives of auditor in accordance with SA 450			

20.	Accumulation of misstatements identified during the audit			
21.	Consideration of identified misstatements as the audit Progresses			
22.	Communication and correction of misstatements			
23.	Evaluating the effect of uncorrected misstatements			
24.	Communication with those charged with governance			
25.	Written Representation from management regarding effects of uncorrected statements			
26.	Documentation regarding misstatements identified during Audit			
27.	Written Representations			
28.	Written representations as audit evidence			
29.	SA 580- Written Representations			
30.	Objectives of auditor in accordance with SA 580			
31.	From whom Written representations are requested by auditor?			
32.	Written representations about management's Responsibilities			
33.	Why Written representations about management responsibilities are necessary?			
34.	Description of management's responsibilities in the Written representations			
35.	Other Written representations			
36.	Additional Written representations about information provided to the auditor			
37.	Written representations about specific assertions			
38.	Date of and Period(s) covered by Written representations			
39.	Form of Written representations			
40.	Doubt as to the reliability of Written representations			
41.	Requested Written representations not provided			
42.	Disclaimer of opinion in case of non-reliability of Written Representations about management's responsibilities or failure to provide such Written Representations			
43.	Significance of Communication with Those charged with governance			
44.	Who are "Those charged with governance"?			
45.	Scope of SA 260- Communication with Those Charged with Governance			
46.	Objectives of auditor in accordance with SA 260			
47.	Determining appropriate persons with whom to communicate			

48.	Matters to be communicated by auditor			
49.	Communication of auditor's independence in case of listed entities			
50.	The Communication process			
51.	Adequacy of the communication process			
52.	Documentation			
53.	Why communication of significant deficiencies in internal control is necessary?			
54.	Scope of SA 265- Communicating Deficiencies in Internal Control to Those Charged with Governance and Management			
55.	Objective of auditor in accordance with SA 265			
56.	Meaning of "Deficiency in internal control" and "significant deficiency in internal control"			
57.	Determination of significant deficiencies in internal control			
58.	Communication of significant deficiencies in internal control to those charged with governance			

Notes to Add

Notes to Add

OVERVIEW

SA 260	Communication With Those Charged With Governance
SA 265	Communicating Deficiencies In Internal Control To Those Charged With Governance And Management
SA 450	Evaluations of Misstatements Identified During The Audit
SA 560	Subsequent Events
SA 570	Going Concern
SA 580	Written Representations

Excited as he was, to know outcome of audit his friend Shekhar was part of, Sameer called him up one day. He came to know that substantive procedures have already been performed and audit is in its last leg of completion. A question arose in his mind. Is something more to be done? Are there still some procedures left to be performed?

It is in this context, he came to know about "Subsequent events". He was under the impression that audit is concerned only with events occurring up to date of financial statements. However, he rued his elementary understanding. Not only auditor is concerned with events occurring up to date of financial statements, he has also to deal with effects of events occurring up to date of auditor's report. Even after signing audit report, if auditor becomes aware of certain facts, he has to take necessary steps in certain situations. What are those steps and situations?

Apart from this, auditor has to assess whether use of going concern assumption by management in preparation of financial statements is appropriate. Applying his accountancy knowledge of AS 1, he remembered that it is one of the three fundamental accounting assumptions. It means that an enterprise will continue to be in business in foreseeable future. It is the basic assumption which affects how financial statements of an enterprise are prepared. Wow! That is why it is so important for auditors.

He was also considering whether misstatements found during audit have to be informed to the management first. Why it is necessary to do so? The reason behind it must be to provide an opportunity to management to correct those misstatements. Another reason could be of judging response of management to such misstatements. Something new may come to knowledge of auditors before he forms opinion and signs on dotted lines.

Remembering that audit suffers from inherent limitations, he knew that audit procedures are not completely fool-proof. An auditor may falter due to limitations of procedures themselves or due to their faulty selection. In such a case, how can auditor be sure of everything, of completeness of information, of recording of all transactions? That is where written representations come in the picture.

He has understood now reason for lull period in the audit and why an auditor takes time to sign report.

There are still procedures to be performed by auditor after completion of substantive procedures involving detailed checking. An auditor has to deal with effect of subsequent events. He has to obtain sufficient appropriate evidence regarding appropriateness of use by management of going concern assumption in preparation of financial statements. Misstatements identified during audit have to be evaluated and communicated. Communication regarding significant audit findings and other matters is made to those charged with governance. Written representations are obtained. All such procedures are performed before signing of audit report.

Notes to Add

SUBSEQUENT EVENTS

Events Occuring b/w → The date of F.S. → The date of Auditor's Report

+

Facts that became known to Auditor → After the date of Auditor's Report

FS → May be affected → Certain Events → Occur After → Date of FS

↓

Those Provide Evidence

↓

of Conditions

Existed @ | Arose After

The date of FS

Examples

(1) Declaration of Insolvency

↓

of a Major Debtor

↓

Evidence of Recoverability on Date of F.S.

(2) Settling Legal Claim

↓

Reduced Amount

↓

Provision already made on FS

(1) Issue of NEW Share Capital

(2) Planned Merger

(3) Destruction of Significant Inventory

Examples of events providing evidence of conditions that arose after the date of the financial statements

- Issue of new share capital.
- Planned merger of the company.
- Destruction of substantial inventories due to fire between the date of the financial statements and the date of auditor's report.

Subsequent events

- Events occurring between the date of the financial statements and the date of the auditor's report
- Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued
- Facts which become known to the auditor after the financial statements have been issued

Events occurring between the date of the financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report are known as subsequent events.

Consider case of a company which may have planned an agreement to merge between the date of the financial statements and the date of the auditor's report. Or a fire claim amount of an entity receivable from insurance company as on date of financial statements may have been settled at a reduced amount before date of auditor's report. These are some of the examples of subsequent events.

Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events: -

(a) Those that provide evidence of conditions that existed at the date of the financial statements and

(b) Those that provide evidence of conditions that arose after the date of the financial statements.

Examples of events providing evidence of conditions that existed at the date of the financial statements

- Declaration of insolvency of a major debtor of the entity between the date of financial statements and the date of auditor's report providing evidence on the recoverability of the money due from debtor as on date of the financial statements.
- Settling a legal claim outside the court at a reduced amount between the date of financial statements and the date of auditor's report for which provision has already been made in financial statements. It provides evidence on adjustment in provision amount already made in financial statements, if any.

SA 560 Subsequent Events

SA 560 deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.

QUESTIONS

Multiple Choice Questions (MCQ)

1. Which of the following is not an example of subsequent event?

(*a*) Event occurring between date of financial statements and date of auditor's report.

(*b*) Event occurring on date of financial statements.

(*c*) Event occurring after filing audit report with tax authorities. Had such an event been known earlier, auditor would have amended report.

(*d*) Event occurring during course of performing audit procedures after date of financial statements.

Ans. (*b*)

OBJECTIVES OF AUDITOR IN ACCORDANCE WITH SA 560

Obtain
↓
Suff. + Appro. A.E.
↓
Events occurring b/w – Date of FS / Date of Auditors Report
↓
Require
- Adj.
- Disclosure

Obtain
↓
Appro. To FACTS
↓
Became known to Auditor
↓
AFTER the date of Audit Report
↓
Had they been known to the Auditor
↓
At that date
↓
May have caused to amend Audit Report

Notes to Add

The objectives of the auditor are to:

(a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements and

(b) Respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

Notes to Add

AUDIT PROCEDURES RELATING TO EVENTS OCCURRING BETWEEN THE DATE OF THE FINANCIAL STATEMENTS AND THE DATE OF THE AUDITOR'S REPORT

Audit procedures relating to events occurring between the date of the financial statements and the date of the auditor's report

→ Audit previously → No Additional Audit Procedures

↓

If previously applied Audit procedure provided satisfactory conclusion

→ Audit Procedure

- Obtain an understanding of procedures
- Inquiring Mgt. / TCWG
- Reading Minutes of Meeting
  - Owners
  - Mgt.
  - TCWG
- Reading Interim F.S

→ Request — Mgt. / TCWG — Provide W.R. → All events After

↓

Date of FS

- Adjusted
- Disclosed

Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued

Facts became known to the Auditor

- After the date of Auditor Report But Before FS are issued
- After F.S. has been issued

No obligation To Perform any audit Procedure

↓

But

↓

A fact becomes known to Auditor that → Had it been known @ Auditor's Report Date

↓

May have caused to amend the Auditor's Report

Notes to Add

Auditor Shall

Discuss with Mgt. / TCWG

Determine whether F.S. needs amendment

How Mgt. Tends to address?
↓
If Mgt. amends the FS
↓
Auditor shall
↓
Carry
↓
Necessary Audit Procedures → To the date of new Audit Report
+
Provide $\boxed{\text{New Audit Report}}$
↓
Shall not be dated Earlier
↓
Than the date of approval of Amended F.S.

When — [Law / Regulation] — Does Not Prohibit → Mgt.
↓
Restricting the Amendment of F.S. to Subsequent events
↓
Auditor is permitted to Restrict the Audit Procedure
↓
Shall

Amend the Auditor's Report
↓
Include an Additional Date
↓
Restricted to that amendment

Indicates → Audit Procedures are Restricted
↓
To that Event

Provide
New / Amended
Audit Report
↓
Include a st.
EoM / OM
Para
↓
Conveys
↓
Audit Procedures are Restricted
↓
To that Event

Notes to Add

* Mgt. → May not be Required → To amend FS

Law | Regulation | F.R.F.

→ Auditor also → need Not provide

Amended | New

Audit Report

*Where
- Mgt. → Does Not Amend FS
- Auditor → believes → FS needed Amendment

↓

Audit Report

Has Not been provided
↓
To the Entity
↓
Modify the Opinion (SA705)
↓
The provide Audit Report

Has been provided
↓
To the Entity
↓
Notify

Mgt. | TCWG

Not to issue FS to 3rd parties
↓
Before amendment
↓
Still FS issued w/o Amendment
↓
Take Appro. Action
↓
To seek to prevent Reliance on Audit Report

Notes to Add

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following: -

AUDIT PROCEDURES RELATING TO EVENTS OCCURRING BETWEEN THE DATE OF THE FINANCIAL STATEMENTS AND THE DATE OF THE AUDITOR'S REPORT

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

Reading the entity's latest subsequent interim financial statements, if any.

Such information may also be obtained by auditor from accounting records pertaining to period after date of financial statements, reading entity's latest available budgets etc.

When, as a result of the procedures performed, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Meaning of "Date the financial statements are issued"

It reflects the date that the auditor's report and audited financial statements are made available to third parties. The date the financial statements are issued generally depends on the regulatory environment of the entity. In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

QUESTIONS

Multiple Choice Questions (MCQ)

2. An auditor of a company communicates significant findings from audit with those charged with governance in the company. Which of the statements is false in regard to communication made?
   (*a*) Evaluation of adequacy of communication process is required on part of the auditor
   (*b*) Planned scope and timing of audit has also to be communicated
   (*c*) Communication of rationale behind audit procedures is necessary
   (*d*) Significant difficulties encountered during audit, if any, have to be communicated

Ans. (*c*)

Theory Questions

1. Discuss meaning of "Date the financial statements are issued" under SA 560.

Ans. Refer to topic on "Meaning of "Date the financial statements are issued" under SA 560.

FACTS WHICH BECOME KNOWN TO THE AUDITOR AFTER THE DATE OF THE AUDITOR'S REPORT BUT BEFORE THE DATE THE FINANCIAL STATEMENTS ARE ISSUED

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance.
(b) Determine whether the financial statements need amendment and, if so,
(c) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall:

Carry out the audit procedures necessary in the circumstances on the amendment.

(a) Unless the circumstances in succeeding para apply: -
   (*i*) Extend the audit procedures, already referred, to the date of the new auditor's report and
   (*ii*) Provide a new auditor's report on the amended financial statements.

The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

When law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events to that amendment. In such cases, the auditor shall either: -

(a) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements or

(b) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter(s) paragraph that conveys that auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor's report. However, when management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then: -

(a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by SA 705 and then provide the auditor's report or

(b) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report.

- **Facts which become known to the auditor after the financial statements have been issued**

After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, when, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall: -

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment and, if so,

(c) Inquire how management intends to address the matter in the financial statements.

If the management amends the financial statements, the auditor shall:

(a) Carry out the audit procedures necessary in the circumstances on the amendment.

(b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.

(c) Unless such circumstances when law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment apply: -

  (*i*) Extend the audit procedures, already referred, to the date of the new auditor's report, and the date the new auditor's report no earlier than the date of approval of the amended financial statements and

  (*ii*) Provide a new auditor's report on the amended financial statements.

(d) When the circumstances are such that law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, amend the auditor's report, or provide a new auditor's report as already discussed.

The auditor shall include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report.

If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

(a) Overview of auditor's responsibilities regarding subsequent events between the date of the financial statements and the date of the auditor's report

Checkbox	Auditor's responsibilities regarding subsequent events
✔	Perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
✔	If such subsequent events that require adjustment of, or disclosure in, the financial statements have been identified, it shall be determined whether each such event is appropriately reflected in those financial statements.
✔	Obtain a written representation from management or those charged with governance that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

(b) Overview of auditor's responsibilities after the date of the auditor's report but before the date the financial statements are issued

Checkbox	Auditor's responsibilities after the date of the auditor's report but before the date the financial statements are issued
✔	No obligation for auditor to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, determine if financial statements need amendment.
✔	If management amends financial statements, carry out audit procedures on amendment and extend the procedures to date of new audit report and provide new auditor's report on amended financial statements.

Checkbox	Auditor's responsibilities after the date of the auditor's report but before the date the financial statements are issued
✔	When management does not amend the financial statements in circumstances where the auditor believes they need to be amended and auditor's report has not been provided to the entity, the auditor shall modify the opinion as required by SA 705 and then provide the auditor's report.
✔	If the auditor's report has already been provided to the entity, the auditor shall notify management not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report.

(c) Overview of auditor's responsibilities after the financial statements have been issued

Checkbox	Auditor's responsibilities after the financial statements have been issued
✔	No obligation to perform any audit procedures regarding financial statements after the financial statements have been issued. However, after financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, determine if financial statements need amendment.
✔	If the management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment.
✔	Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation. Extend the audit procedures, already referred, to the date of the new auditor's report and provide a new auditor's report on the amended financial statements.
✔	Include in the new auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.
✔	If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

Test Your Understanding

1. CA PK Jacob is conducting audit of a company for year 2021-22. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2022. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2022 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2021. The management of company has decided to agree to an out of court settlement of ₹5 crore to protect its reputation. The financial statements of the company are silent on this issue.

   Discuss, how, CA PK Jacob should proceed to deal with above issue.

Ans. In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of company has agreed to an out of court settlement of ₹5 crore. It is an example of subsequent event between the date of the financial statements and the date of the auditor's report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements. He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider impact on auditor's report.

2. CA Chandni Khanna is going to complete audit of a company within next few days. She has performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings held after date of financial statements, going through books of accounts after date of financial statements to make sure that all subsequent events before signing audit report have been considered by her. Still, she wants to be certain that no such events have been left out. What she should do in such a situation? Also, discuss the rationale of doing so.

Ans. She has already performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings after date of financial statements and going through books after date of financial statements.

Now, she should request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

The rationale of obtaining written representations is that even after performing abovesaid procedures, she may not come to know all subsequent events. Therefore, it is necessary from an auditor's point of view to obtain acknowledgment from management in the form of Written representations that all such events for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Notes to Add

Notes to Add

MEANING OF GOING CONCERN AND ITS SIGNIFICANCE

F.S. are prepared → on assumption that

Entity is a Going Concern

Will continue its operations for a foreseeable future

UNLESS

↓

Mgt.

Intends to

Liquidate the Entity

Cease Operations

has

No realistic alternative

→ When enterprise → Not Viewed → as going concern

↓

FS are prepared → Liquidation Basis

SA 570 GOING CONCERN

→ Auditor's Responsibility in
- Audit
- Auditor's Report

RESPONSIBILITY FOR ASSESSMENT OF THE ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN

Preparation of FS → By Mgt. → Assess Entity's ability

↓

To Continue as going concern

↓

Even if F.R.F. do not include an explicit req.

→ Factors Relevant to Mgt. judgement

Degree of uncertainity associated

Size / complexity of the entity

Info available at the time of

- Judgement
- Subsequent event

Going concern is one of the fundamental accounting assumptions. The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

The significance of Going Concern is due to its effect on preparation of financial statements. Ability or otherwise of an enterprise to be viewed as going concern affects its preparation of financial statements.

When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

When an enterprise is not viewed as a going concern, the financial statements are prepared on liquidation basis. For example, inventories may need to be written down as these may be sold for a lower price. Assets may have to be recorded at the likely prices they will fetch.

Notes to Add

SA 570 Going Concern deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.

The preparation of the financial statements requires management to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment: -

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

RESPONSIBILITIES OF THE AUDITOR & OBJECTIVES OF AUDITOR IN ACCORDANCE WITH SA 570

To obtain	To Conclude	To Report
Suff. + Appro. A.E.	↓	↓
↓	Based on A.E. obtained	as per SA
Mgt. use of going Cocern	↓	
	Material uncertainity?	

→ Absence of Material uncertainity ≠ Guarantee → Entity's ability to continue as going Concern

Notes to Add

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding and conclude on the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding and conclude on the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;

(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

(c) To report in accordance with this SA.

OBJECTIVES

- Toobtainsufficientappropriateauditevidenceregarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;
- To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
- To report in accordance with this SA.

Notes to Add

RISK ASSESSMENT PROCEDURES AND RELATED ACTIVITIES

When performing R.A.P. → Auditor shall

↓

Stage 1

- Consider
  ↓
  Whether — Events / Conditions — Exists
  ↓
  That may cast significant doubt
  ↓
  Entity's ability to continue as G.C.
- Determine
  ↓
  Mgt. has performed
  ↓
  Preliminary assessment
  - Yes
    - Disscuss assessment with Mgt.
    - Determine Mgt. identified
      - Events
      - Conditions
    - Mgt. plans to address
  - No
    - Discuss
      ↓
      Basis for intended use of G.C.
    - Inquire
      - Events
      - Conditions

→ Events & Conditions → that may cast significant Doubt on Entity's ability to continue as a going concern

Eg.:

Financial	Operating	Others
(1) Short term loans against F.A.	(1) Loss of Major F.A.	(1) Assets not enough to cover the claims of Litigation
(2) Entity not able to service its interest	(2) Strikes in the Entity	

Notes to Add

When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern and: -

(a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them or

(b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

Examples of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

- The following are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern

Financial events or conditions

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets
- Indications of withdrawal of financial support by creditors
- Negative operating cash flows indicated by historical or prospective financial statements
- Adverse key financial ratios
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with the terms of loan agreements
- Change from credit to cash-on-delivery transactions with suppliers
- Inability to obtain financing for essential new product development or other essential investments

Operating events or conditions

- Management intentions to liquidate the entity or to cease operations
- Loss of key management without replacement
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s)
- Labour difficulties
- Shortages of important supplies
- Emergence of a highly successful competitor

Other events or conditions

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy
- Changes in law or regulation or government policy expected to adversely affect the entity
- Uninsured or underinsured catastrophes when they occur

Notes to Add

Notes to Add

EVALUATING MANAGEMENT'S ASSESSMENT

(1) Auditor → Evaluate → Mgt. assessment of G.C.

↓

Key part of Auditor's consideration of Mgt.'s use of G.C.

(2) Not Auditor's Responsibility → Rectify → Lack of analysis

↓

By Mgt.

(3) Auditor → cover → same period → used by Mgt.

↓

At least 12 months

Notes to Add

EVALUATING MANAGEMENT'S ASSESSMENT

The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of management's use of the going concern basis of accounting.

It is not the auditor's responsibility to rectify the lack of analysis by management. In some circumstances, however, the lack of detailed analysis by management to support its assessment may not prevent the auditor from concluding whether management's use of the going concern basis of accounting is appropriate in the circumstances.

For example, when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether management's use of the going concern basis of accounting in the preparation of the financial statements is appropriate in the circumstances.

In other circumstances, evaluating management's assessment of the entity's ability to continue as a going concern, may include an evaluation of the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future action and whether management's plans are feasible in the circumstances.

In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements, the auditor shall request management to extend its assessment period to at least twelve months from that date.

Notes to Add

ADDITIONAL AUDIT PROCEDURES WHEN EVENTS OR CONDITIONS ARE IDENTIFIED

Additional Audit Procedures → When Events / Conditions are identified

↓

Determine whether Material uncertainties exists

↓

That may cast doubt on Entity's ability to continue as Going Concern

↓

The performing **ADDITIONAL AUDIT PROCEDURES**

(incl: Consideration of Mitigation factors)
(Controls used to Manage & Handle risk)

- Determine whether Mgt. Has assessed the entity's ability to continue as going concern → If Not request then to do so
- Evaluate Mgt.'s plan for future action → whether outcome
  - Improve Situation
  - Feasible
- Whether Entity has prepared cash flow forecast + Analysis of Forecast is a significant factor + in evaluating Mgt.'s plan for future action.
  - Reliability of Data
  - Adequate support for assumption
- Whether any additional facts/info. Became available → After Mgt. assessment
- Requesting W.R. from Mgt.

Notes to Add

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include: -

(a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.

(b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

(c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:

  (*i*) Evaluating the reliability of the underlying data generated to prepare the forecast; and

  (*ii*) Determining whether there is adequate support for the assumptions underlying the forecast.

(d) Considering whether any additional facts or information have become available since the date on which management made its assessment.

(e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

Examples of audit procedures when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as going concern

- Analysing and discussing cash flow, profit and other relevant forecasts with management
- Analysing and discussing the entity's latest available interim financial statements
- Reading the terms of debentures and loan agreements and determining whether any have been breached
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds
- Evaluating the entity's plans to deal with unfilled customer orders
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern
- Confirming the existence, terms and adequacy of borrowing facilities
- Obtaining and reviewing reports of regulatory actions
- Determining the adequacy of support for any planned disposals of assets

QUESTIONS

Multiple Choice Questions (MCQ)

3. Which of the following is not an example of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern?

   (*a*) Adverse key financial ratios

   (*b*) Inability to invest in modernisation of plant

   (*c*) Inability to pay creditors on time

   (*d*) Inability to pay salary of staff

Ans. (*b*)

Notes to Add

Notes to Add

AUDITOR'S CONCLUSIONS

AUDITOR'S CONCLUSIONS

↓

If material uncertainity exists → Appro. Disclosure

- Nature
- Implication

ADEQUACY OF DISCLOSURES WHEN EVENTS OR CONDITIONS HAVE BEEN IDENTIFIED AND A MATERIAL UNCERTAINTY EXISTS

Auditor concludes
- Mgt. use of G.C. → Appro.
- Material uncertainity → exists

↓

Determine → F.S.
- Adequately disclose
  - Principal
    - Event
    - Conditions
  - Mgt.'s plan to deal
- Disclose clearly
  - Material uncertainity
  - May be unable to
    - Realise Assets
    - Discharge Liabilities

Auditor → Evaluate → F.S. provide → Adequate Disclosure
- Events
- Conditions

Notes to Add

The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary.

Adequacy of disclosures when events or conditions have been identified and a material uncertainty exists

If the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements: -

(a) Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions.

Notes to Add

IMPLICATIONS FOR THE AUDITOR'S REPORT

If use of G.C. basis of Accounting

- Inappropriate
  ↓
  F.S. → prepared → G.C. Basis

  Auditor's → Inappropriate opinion
  ↓
  Adverse Opinion

- Appropriate
  +
  Material uncertainity exists
  ↓
  Adequate Disclosure
  - Made in F.S.
    ↓
    Unmodified opinion
    +
    Separate section
    ↓
    Heading: "Material uncertainity Relating to G.C."
    - Draw attention to the note in F.S.
    - State
      - Events
      - Events
      ↓
      Indicate Material uncertainity
      +
      Auditor's opinion is not modified
  - Not made in F.S.
    ↓
    Qualified/Adverse opinion (as per SA705)
    +
    "Basis for qualified/adverse opinion" section
    ↓
    Material uncertainity exists
    +
    FS not adequately disclose this matter

- Mgt. unwilling
  - Make
  - Extend

  Assessment
  ↓
  Qualified/Disclaimer of opinion

Notes to Add

(I) If use of Going concern basis of accounting is inappropriate

If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

(II) If use of going concern basis of accounting is appropriate but a material uncertainty exists

(A) Adequate Disclosure of a Material Uncertainty is made in the Financial Statements

If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to: -

(*a*) Draw attention to the note in the financial statements that discloses such matters.

(*b*) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

(*c*) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

(*i*) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705.

(*ii*) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

(III) Management unwilling to make or extend its assessment

If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report. In such a situation, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements.

Overview of auditor's responsibilities regarding Going Concern

Checkbox	Auditor's responsibilities regarding going concern
✓	Obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.
✓	Conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.
✓	Report in accordance with SA 570.

Test Your Understanding

3. During course of audit of a company, CA. Varun Aggarwal notices that company is facing significant skilled labour shortages resulting in hampering of operations of company. The company's manufacturing is dependent upon skilled labour coming from villages in certain districts of Eastern UP. However, due to job opportunities available near villages now, many are not interested in going out from their native villages.

   Such a situation has led to company not being able to keep its commitments, losing out on orders and fall in its revenues. Fixed costs of the company remain at a high level. As a result, company is facing a liquidity crunch and is not able to pay its creditors on time. The bankers of company are also not willing to help the company to tide over liquidity crisis. The auditor is having doubts over going concern status of the company.

   How should management of the company try to address auditor's concerns? What audit procedures may be performed by auditor in such a situation?

Ans. Significant shortage of skilled labour, inability to pay creditors on time and overall liquidity crisis faced by the company are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

In such a situation, management should try to address auditor's concerns by preparing its future plan of action including preparation of cash flow forecast showing inflow and outflow of cash. Such a cash flow forecast should address auditor's concerns regarding liquidity crisis being faced by the company.

The auditor should perform audit procedures to evaluate the reliability of the underlying data to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast. The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

QUESTIONS

Theory Questions

2. The auditor of a company is having concerns about following of going concern basis of accounting followed by management for preparation of financial statements. It asks the management to justify preparation of financial statements. However, management is not willing to make its assessment and share with auditor. What are implications for auditor's report in such a scenario?

Ans. If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report. In such a situation, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements.

3. M/s ANS & Associates has been appointed as the statutory auditors of MNO Ltd. The company has been suffering losses due to the emergence of highly successful competitor, thereby leading to negative networth. Also, the sales head, key management personnel, of the company left the company due to health issues. When CA Amar, the engagement partner discussed the scenario with the management of the company, he did not get any satisfactory reply from the management. What is the responsibility of M/s ANS & Associates with regard to SA 570?

Ans. As per SA 570, one of the objectives of the auditor regarding going concern is to obtain sufficient and appropriate audit evidence regarding the same and to conclude on the appropriateness of the management's use of the going concern basis of accounting in the preparation of the financial Further it also contains the list of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern which are:

- Financial indicator- Negative networth
- Operating indicator- Loss of key management and emergence of highly successful competitor.
- In the present case, MNO Ltd. has negative networth on account of emergence of highly successful competitor and the sales head of the company has also left the company.
- Also, CA Amar did not get any satisfactory reply when he discussed the going concern matter with the management.
- Thus, from the above facts, it appears that MNO Ltd. is not going concern.
- If the management of MNO Ltd. has used the going concern basis of accounting, the auditor should first ask the management to adjust the financial statements.
- If the management of MNO Ltd. does not agree with the same, CA Amar shall consider the impact on his audit report.

Notes to Add

EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

Before → Forming an opinion on F.S.

↓

Auditor → (I) Considers Materiality

(II) Evaluates effects — Identified / Uncorrected — Misstatement

(1) SA 450 Evaluation of Misstatements Identified during the Audit

+

Uncorrected Misst.

(2) Objectives of auditor in accordance with SA 450

Evaluate → Effect — Identified / Uncorrected — Misst

The objective of the auditor is to evaluate: -

(*a*) The effect of identified misstatements on the audit and

(*b*) The effect of uncorrected misstatements, if any, on the financial statements.

ACCUMULATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

Auditor → Accumulate Misst. → Identified during an Audit

↓

Except → Trivial (Immaterial) Misst.

Notes to Add

Before forming an opinion on the financial statements, the auditor evaluates effects of identified misstatements on the audit and of uncorrected misstatements on financial statements after consideration of materiality. Uncorrected misstatements refer to those misstatements that the auditor has accumulated during the audit and that have not been corrected.

Notes to Add

SA 450 deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Notes to Add

The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. A misstatement may arise from a variety of factors. For example, an inaccuracy in gathering or processing data from which financial statements are prepared or an omission of an amount or disclosure can result into a misstatement.

An entity has wrongly capitalized machinery repair expenses amounting to Rs.5 lacs resulting in overstatement of profits. It is an example of misstatement.

Notes to Add

CONSIDERATION OF IDENTIFIED MISSTATEMENTS AS THE AUDIT PROGRESSES

Auditor → Determine → need to Revise — O.A.S. / Audit plan

↓

If

- Nature of Identified Misst. / Circumstances of their occurance — Indicate
  ↓
  Other Misst. May Exist
  \+
  When accumulated → Could Be Material
- Accumulated Misst.
  ↓
  Approaches
  ↓
  Materiality (DM)

* Auditor May Request Mgt. to

- Examine — CoT / Alc Bal. / Disclosure
  ↓
  To understand Cause of Misst.
  ↑
  Identified by Auditor
- Perform procedures
  ↓
  To determine
  ↓
  Amount of Actual Misst.

→ If Mgt. Accepts → Auditor's Request → Examine — CoT / Alc Bal. / Disclosure + Corrected Misst.

↓

Auditor → perform → Additional Audit procedures

↓

To detemine

↓

Misst. Remain?

Notes to Add

The auditor shall determine whether the overall audit strategy and audit plan need to be revised if: -

(a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material or

(b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.

The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements.

If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain.

Notes to Add

COMMUNICATION AND CORRECTION OF MISSTATEMENTS

Timely Basis
↑
Auditor → communicate → All Accumulated Misst.
+
Request to correct
↓
Appro. Level of Mgt. → unless prohibited — Law / Regulation

If Mgt. → Refuses
↓
Auditor shall
- Obtain understanding
  ↓
  Mgt. Reason for refusal
- Evaluate whether F.S. as a whole are free from MM

Notes to Add

EVALUATING THE EFFECT OF UNCORRECTED MISSTATEMENTS

Step 1 : Reassess Materiality
Step 2 : Evaluate → Effect of uncorrected Misst.
↓
Consider
- Size / Nature — of Misst.
  - CoT
  - Alc Bal.
  - Disclosure
    - F.S. as a whole
    - Particular circumstances
- Effect of uncorrected Misst.
  ↓
  Related to prior pd.

The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees and take action as necessary.

The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

QUESTIONS

Multiple Choice Questions (MCQ)

4. Which of the following is false regarding communication of misstatements identified during course of an audit?

(*a*) The auditor should request those charged with governance for correction of identified misstatements.

(*b*) The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is material.

(*c*) The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is immaterial.

(*d*) The auditor should communicate effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Ans. (*b*)

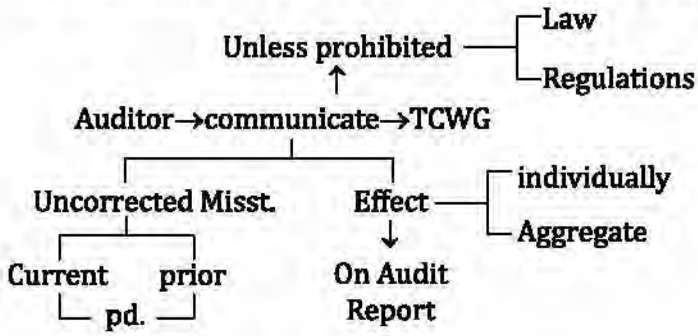
Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results.

The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider: -

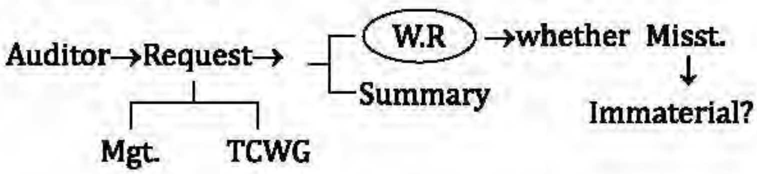
(a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence and

(b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

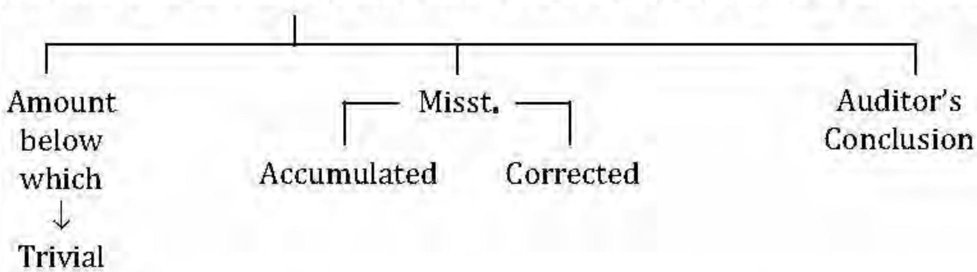
COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE



WRITTEN REPRESENTATION FROM MANAGEMENT REGARDING EFFECTS OF UNCORRECTED STATEMENTS



DOCUMENTATION REGARDING MISSTATEMENTS IDENTIFIED DURING AUDIT



Notes to Add

The auditor shall communicate with those charged with governance regarding uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.

The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Notes to Add

....

....

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

The audit documentation shall include:

(a) The amount below which misstatements would be regarded as clearly trivial;

(b) All misstatements accumulated during the audit and whether they have been corrected; and

(c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

Overview of auditor's responsibilities regarding evaluation of misstatements identified during the audit

Checkbox	Auditor's responsibilities regarding evaluation of misstatements identified during the audit
✔	Accumulate misstatements identified during the audit other than those that are clearly trivial.
✔	Consider if the above process indicates that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material or the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.
✔	If so, consider if revision is necessary in audit strategy and plan.
✔	Communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management and request for correction of all misstatements.

✓	Upon management refusal to correct some or all of the misstatements communicated, obtain an understanding of management's reasons for not making the corrections and consider the same at time of evaluating whether the financial statements as a whole are free from material misstatement.
✓	In case of failure of management to correct all of the misstatements, reassess materiality to confirm whether it remains appropriate in the context of the entity's actual financial results.
✓	Determine whether uncorrected misstatements are material, individually or in aggregate.
✓	Communicate with those charged with governance regarding uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.
✓	Request written representation from management that they believe that effects of uncorrected statements are immaterial.
✓	Maintain documentation.

Test Your Understanding

4. You are nearing completion of audit of a company. On going through your working papers, it is noticed that finished goods inventory was overvalued by ₹2 crore. It has also been noticed that freight of ₹10 lacs paid on import of machinery was charged to statement of profit and loss.

Discuss, how you should, proceed and communicate in above situation before signing audit report.

Ans. The instances highlighted in above situation are examples of misstatements identified during the audit. Over valuation of inventory of finished goods by ₹2 crore and wrongly charging freight of ₹10 lacs paid on machinery to statement of profit and loss instead of capitalizing are examples of misstatements.

The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements. In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality. It should also be considered whether uncorrected statements are material individually or in aggregate. Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

QUESTIONS

Theory Questions

4. Discuss documentation requirements for an auditor regarding misstatements identified during audit under SA 450.

Ans. Refer to topic on "Documentation regarding misstatements identified during audit"

Notes to Add

WRITTEN REPRESENTATIONS

SA 580 Written Representation

Written statement by Mgt → Provided to Auditor → To confirm

- Certain Matters
- Support other Audit Matters

Written statement by Mgt

↓

DOES NOT INCLUDE

- FS
- Assertions
- Supporting Books & Records

Written statement by management → provided to the auditor → to confirm certain matters or → to support other audit evidence

W.R. as A.E.

W.R. = A.E. → But NOT Suff. + Appro. A.E. → on their own

W.R. → Does Not Affect — Nature (N) / Extent (E) — of other A.E.

If Mgt. — Modifies / Does not provide — W.R. → It may alert Auditor

↓

One more — Significant issues may exist

Notes to Add

Notes to Add

A written representation is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

QUESTIONS

Multiple Choice Questions (MCQ)

5. Written representations are: -

(*a*) Necessary audit evidence

(*b*) Sufficient appropriate audit evidence

(*c*) Not audit evidence

(*d*) Audit evidence depending upon auditor's professional judgment

Ans. (*a*)

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Written representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfilment of management's responsibilities, or about specific assertions.

SA 580- WRITTEN REPRESENTATIONS

Auditor's Responsibility → To obtain WR
- Mgt
- TCWG

OBJECTIVES OF AUDITOR IN ACCORDANCE WITH SA 580

Auditor's objectives Regarding W.R.

- **To obtain W.R.** → **Fullfiled responsibility** → **Preparation of F.S.**
- **To support other A.E.** → **Relevant to**
  - **F.S.**
  - **Specific assertions**
- **To Respond Appropriately** → **To W.R.**
  - **Mgt.**
  - **TCWG**

Objectives of auditor regarding written representation
- To obtain Written Representations
- To support other evidence
- To respond appropriately

FROM WHOM WRITTEN REPRESENTATIONS ARE REQUESTED BY AUDITOR?

Auditor → obtain W.R. → Mgt. → Appro. Responsibilities
- F.S.
- Matters

Notes to Add

SA 580- Written representations deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.

The objectives of the auditor are:

(a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and

(c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. Written representations relate to fulfilment of management's responsibilities or to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.

Notes to Add

WRITTEN REPRESENTATIONS ABOUT MANAGEMENT'S RESPONSIBILITIES

Management's responsibilities

- Preparation of F.S. ↓ App. F.R.F. + Fair presentation
- Info provided + Access as agreed
- Completeness of transaction

→ Individuals → specialised knowledge
- Actuary
- Staff engineers
- Internal counsel

May include Qualifying Language → That Representations (WR) are made ↓ TO THE BEST OF ITS KNOWLEDGE & BELIEFS

Notes to Add

Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in following areas: -

(I) Preparation of the financial statements

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement.

Due to its responsibility for the preparation and presentation of the financial statements and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:

- An actuary responsible for actuarially determined accounting measurements.
- Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
- Internal counsel who may provide information essential to provisions for legal claims.

In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations. To reinforce the need for management to make informed representations, the auditor may request that management include in the written representations, confirmation that it has made such inquiries as it considered appropriate to place it in the position to be able to make the requested written representations.

(II) Information provided and completeness of transactions

The auditor shall request management to provide a written representation that:

(*a*) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement and

(*b*) All transactions have been recorded and are reflected in the financial statements.

Notes to Add

WHY WRITTEN REPRESENTATIONS ABOUT MANAGEMENT RESPONSIBILITIES ARE NECESSARY?

A.E. obtained → Mgt. has fulfilled → Responsibilities

↓

NOT SUFFICIENT

↓

Without confirmation

↓

From Mgt. → That it BELIEVES

↓

It has fulfilled those Responsibilities

Responsibilities:

- Preparation of F.S.
- Info provided + Completeness of transaction

THIS IS PARTICULARLY APPROPRIATE WHEN

- **Those who Signed the Terms of Audit Engagement ↓ On behalf of the Entity ↓ No Longer Have The Relevant Responsibilities**
- **Terms of Audit Engagement ↓ Were prepared in the previous F.Y.**
- **Indication ↓ That Mgt ↓ Misunderstood its Responsibilities**
- Δ in Circumstance

Notes to Add

Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.

For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.

The written representations requiring fulfilment of management responsibilities in relation to above draw on the agreed acknowledgement and understanding of management of its responsibilities in the terms of the audit engagement by requesting confirmation that it has fulfilled them. The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations.

This is particularly appropriate when:

- Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- The terms of the audit engagement were prepared in a previous year ;
- There is any indication that management misunderstands those responsibilities; or
- Changes in circumstances make it appropriate to do so.

Description of management's responsibilities in the Written representations

Management's responsibilities shall be described in the "Written representations required about management responsibilities" in the manner in which these responsibilities are described in the terms of the audit engagement.

Notes to Add

OTHER WRITTEN REPRESENTATIONS

- Selection + Application
  - A/c Policies
- Other matters
  - Plans/Intentions ↓ That may affect
    - Carrying value
    - Classification
      - Assets / Liabilities
  - Actual / Contingent ↓ Liabilities
  - Title / Control ↓ Assets
  - Non compliance ↓ Law / Regulation

Notes to Add

....

....

....

....

....

ADDITIONAL WRITTEN REPRESENTATIONS ABOUT INFORMATION PROVIDED TO THE AUDITOR

↓

That it has communicated → To Auditor

↓

All Deficiencies in I.C.

↓

Of which Mgt. is aware

Notes to Add

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Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.

In addition to the written representation about management's responsibilities regarding preparation of financial statements, the auditor may consider it necessary to request other written representations about the financial statements. Such written representations may supplement, but do not form part of, the written representation relating to management's responsibilities regarding preparation of financial statements. They may include representations about the following: -

- Whether the selection and application of accounting policies are appropriate; and
- Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework: -
    - Plans or intentions that may affect the carrying value or classification of assets and liabilities;
    - Liabilities, both actual and contingent;
    - Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
    - Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

In addition to the written representation required by auditor regarding management responsibility about information provided to auditor, the auditor may consider it necessary to request management to provide a written representation that it has communicated to the auditor all deficiencies in internal control of which management is aware.

Notes to Add

WRITTEN REPRESENTATIONS ABOUT SPECIFIC ASSERTIONS

When obtaining A.E. → about
- Evaluating
- Judgements
- Intentions

↓

Auditor may consider

Entity's past history	Entity's Reasons	Entity's Ability	Existence / Lack of other info
↓	↓	↓	↓
In carrying out stated intentions	Particular course of action	To pursue specific course of action	That may be inconsistent with Mgt.

Mgt.
- Judgement
- Intent

Notes to Add

DATE OF AND PERIOD(S) COVERED BY WRITTEN REPRESENTATIONS

Date & Period (s) covered by W.R.

As near as practicable → to Auditor's Report But NOT AFTER because Auditor is concerned with events up to the date of Auditor's Report

W.R. → for all [F.S. / Period(s)] — referred in Auditor's Report

Notes to Add

When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:

- The entity's past history in carrying out its stated intentions.
- The entity's reasons for choosing a particular course of action.
- The entity's ability to pursue a specific course of action.
- The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements, in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion.

For example, if the intent of management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Because written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

Notes to Add

FORM OF WRITTEN REPRESENTATIONS

(i) Representation Letter → addressed to Auditor

(ii) If [Law / Regulation] requires → written public statement
↓
Auditor will determine → Such W.R. provides
- Some/All of Representations
- Relevant Matters

Notes to Add

The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required regarding management responsibilities, the relevant matters covered by such statements need not be included in the representation letter.

Illustrative Written representation letter

On the letterhead of the entity

To

PJ Shrimali & Co. 15th July, 2022

Chartered Accountants

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of XXXX Limited for the year ended March 31, 2022 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view in accordance with the applicable accounting standards in India.

We confirm that (to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated 17th August 2021, for the preparation of the financial statements in accordance with financial reporting Standards, in particular, the financial statements give a true and fair view in accordance with the applicable accounting standards in India.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of applicable accounting standards in India. (SA 550)
- All events subsequent to the date of the financial statements and for which applicable accounting standards in India require adjustment or disclosure have been adjusted or disclosed. (SA 560)
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (SA 450)

Information provided

- We have provided you with:
- Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
- Additional information that you have requested from us for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.

- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves: -
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements.
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (SA 550)
- Chief Financial Officer

Notes to Add

DOUBT AS TO THE RELIABILITY OF WRITTEN REPRESENTATIONS

If Auditor has concerns → Competency, Integrity, Ethical Values, Diligence, commitment

↓

To determine → Effect of such concerns

+

If W.R. → Inconsistent → Other A.E.

↓

Perform Audit procedures to Resolve

+

If matter remains → Unresolved → determine the effect

+

If Auditor, Concludes → W.R. → Not Reliable

+

Take appropriate action

REQUESTED WRITTEN REPRESENTATIONS NOT PROVIDED

(1) Discuss matter with Mgt.

(2) Re-evaluate the Integrity of Mgt.

+

Evaluate the reliability of W.R.

(3) Take appropriate action

DISCLAIMER OF OPINION IN CASE OF NON-RELIABILITY OF WRITTEN REPRESENTATIONS ABOUT MANAGEMENT'S RESPONSIBILITIES OR FAILURE TO PROVIDE SUCH WRITTEN REPRESENTATIONS

Auditor → Disclaim an Opinion → If

- Suff. Doubt → Integrity of Mgt.
  ↓
  W.R. → NOT RELIABLE
- Mgt. → Does not provide
  ↓
  W.R.

If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations and audit evidence in general.

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations and audit evidence in general.

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705, having regard to the requirement of disclaimer of opinion.

Notes to Add

If management does not provide one or more of the requested written representations, the auditor shall: -

(a) Discuss the matter with management;

(b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations and audit evidence in general; and

(c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705 having regard to the requirement of disclaimer of opinion.

The auditor shall disclaim an opinion on the financial statements in accordance with SA 705 if:

(a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations about management fulfilling its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions are not reliable; or

(b) Management does not provide the written representations relating to fulfilling its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions.

Overview of auditor's responsibilities regarding Written representations

Checkbox	Auditor's responsibilities regarding Written representations
✓	Obtain Written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor.

✓	Obtain Written representations to support other audit evidence relevant to the financial statements or specific assertions in the financial statements, if determined necessary by the auditor or required by other SAs.
✓	Disclaim opinion on financial statements in accordance with SA 705 in case of non-reliability of Written representations about management responsibilities or non-providing of Written representations about management responsibilities.

Test Your Understanding

5. CA R Gurumurthy is about to complete audit of a company. Before completion, he asks management to provide him a written representation confirming that management has fulfilled its responsibilities regarding preparation of financial statements. He also wants management to confirm in writing about providing of all the necessary information and completeness of transactions to him. The management feels that auditor is seeking irrelevant documents near the completion of audit. Why view of management is not proper? What possible implications it may lead to?

Ans. The view of management is not proper. Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.

In case of refusal of management to provide such a confirmation, it may lead to disclaimer of opinion by the auditor.

Notes to Add

SIGNIFICANCE OF COMMUNICATION WITH TCWG

Auditor ←Communication→ TCWG

↓

Important in Assisting

- Understanding → Matters → Related to Audit
- Obtaining → Info → Relevant to Audit
- Fulilling → TCWG → Responsibilities

Notes to Add

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....

....

WHO ARE "THOSE CHARGED WITH GOVERNANCE"?

*TCWG — Person (s) / Org. (s) [Corporate Trustee] — Responsibility→Overseeing

- Strategic Direction
- Accounting obligations
- F.R. process

of entity

Communication from auditor is important with those charged with governance. An effective two-way communication is important in assisting:

(a) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.

(b) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and

(c) Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

QUESTIONS

Theory Questions

5. In what ways an effective two-way communication between auditor and those charged with governance is important?

Ans. Refer to topic on "Significance of Communication with Those charged with governance."

The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Governance structures vary by entities, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example, in some entities, a supervisory board exists that is separate from executive board. In other entities, both supervisory and executive functions are performed by a single board. In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure.

For example, company directors. In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.

In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee.

Such diversity means that it is not possible to specify for all audits the persons with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate persons with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities and some not-for-profit organizations.

In such cases, the auditor may need to discuss and agree with the engaging party the relevant persons with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with SA 315 is relevant. The appropriate persons with whom to communicate may vary depending on the matter to be communicated.

SA 260 deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.

OBJECTIVES OF AUDITOR IN ACCORDANCE WITH SA 260

- Communicate → TCWG → Responsibilities of Auditor
- Obtain → TCWG → Relevant info.
- Provide → TCWG → Timely observations
- Promote → Effective communication

Notes to Add

The objectives of the auditor are:

(a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;

(b) To obtain from those charged with governance information relevant to the audit;

(c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process and

(d) To promote effective two-way communication between the auditor and those charged with governance.

Objectives of auditor as per SA 260

- To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
- To obtain from those charged with governance information relevant to the audit;
- To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process and
- To promote effective two-way communication between the auditor and those charged with governance.

The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate.

Notes to Add

MATTERS TO BE COMMUNICATED BY AUDITOR

- Auditor's Responsibilities
  - Forming + Expressing ↓ opinion
  - Audit ↓ Does not relieve
    - Mgt.
    - TCWG
- Planned
  - Scope
  - Timing
  - + Communication of Significant risks
- Significant Findings
  - Qualitative Aspects
    - A/c Practice
    - A/c policies
    - A/c Estimates
    - FS Disclosures
  - Diflculties
  - Matter + W.R. ↓ Unless TCWG manages the entity
  - Form + Content ↓ Audit Report
  - Other Matters

Notes to Add

Following matters are required to be communicated by auditor with those charged with governance: -

(I) The auditor's responsibilities in relation to the financial statement audit The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

(*a*) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance and

(*b*) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

(II) Planned scope and timing of the audit

The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor.

(III) Significant findings from the audit

The auditor shall communicate with those charged with governance: -

(*i*) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity

(*ii*) Significant difficulties, if any, encountered during the audit;

(*c*) Unless all of those charged with governance are involved in managing the entity: -

  (*i*) Significant matters arising during the audit that were discussed, or subject to correspondence, with management;

  (*ii*) Written representations the auditor is requesting

(*d*) Circumstances that affect the form and content of the auditor's report, if any and

(*e*) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

Notes to Add

COMMUNICATION OF AUDITOR'S INDEPENDENCE IN CASE OF LISTED ENTITIES

- Statement
  - Engagement team
  - Others In Firm
  - Firm
  - Network Firms
  - Complied with → Relevant ethical Req.
- Relationships + Other matters
- Related Safeguards

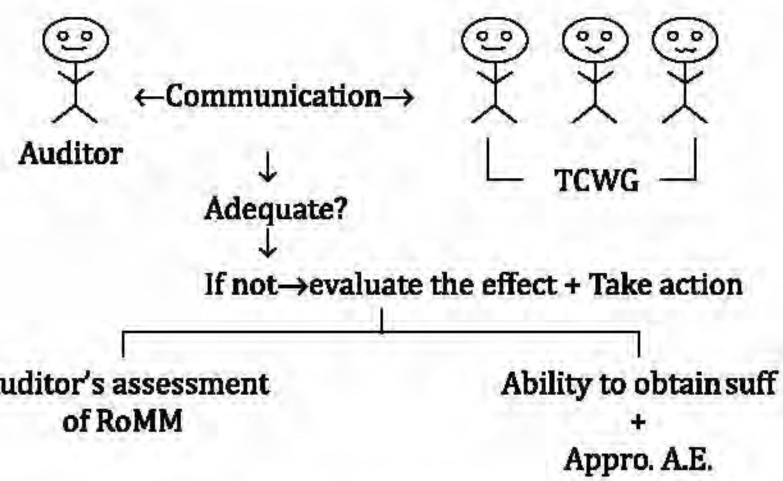
THE COMMUNICATION PROCESS

Auditor → Communicate
- ↑ Timely Basis
- ↓ Writing
- Form
- Timing
- Expected general content
- Independence (Only ListedEnities)

Notes to Add

....

ADEQUACY OF THE COMMUNICATION PROCESS



In the case of listed entities, the auditor shall communicate with those charged with governance:

(a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence and

(b)

(*i*) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity.

These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor and

(*ii*) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

The auditor shall communicate with those charged with governance the form, timing and expected general content of communications.

The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required in case of listed entities.

The auditor shall communicate with those charged with governance on a timely basis.

The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action.

Notes to Add

DOCUMENTATION

Include in Documentation

↑

Where → Matters communicated

- Orally
  - When?
  - To Whom?
- Written
  - ↓ Retain a copy

Notes to Add

SCOPE OF SA 265 - COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT

Auditor's Responsibility → communicate → TCWG

↓ Required

↓ Deficiencies in I.C.

Required

↓

(1) Obtain understanding → I.C.

↓

Stage 1 → Identifying & Assessing RoMM

↓

Auditor consider I.C. ↔ To design Audit Procedures

↕

Not for expressing an opinion → on effectiveness of I.C.

Where matters required by SA 260 to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.

Overview of auditor's responsibilities regarding communicating with those charged with governance

Checkbox	Auditor's responsibilities regarding communicatingwith those charged with governance
✓	Determine the appropriate person(s) within the entity's governance structure with whom to communicate.
✓	Communicate matters relating to auditor's responsibilities in relation to the financial statement audit, planned scope and timing of audit and significant findings from the audit.
✓	In case of listed entities, communicate about auditor's independence.
✓	Retain copy of communication of matters communicated in writing as part of audit documentation. In case of matters communicated orally, include them in the audit documentation stating when and to whom they were communicated.

WHY COMMUNICATION OF SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL IS NECESSARY?

Communicating significant deficiencies in internal control in writing to those charged with governance reflects the importance of these matters and assists those charged with governance in fulfilling their oversight responsibilities.

SA 265 deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements.

The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. SA 265 specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

Notes to Add

OBJECTIVE OF AUDITOR IN ACCORDANCE WITH SA 265

↓

Communicate → TCWG → Deficiencies in I.C.

- Identified during audit
- Sufficiently important

MEANING OF "DEFICIENCY IN INTERNAL CONTROL" AND "SIGNIFICANT DEFICIENCY IN INTERNAL CONTROL"

Deficiency in I.C.

↓

Exists when

Control →Missing

- Designed (D)
- Implemented (I)
- Operated (O)

Unable to

- Prevent (P)
- Detect (D)
- Correct (C)

MM

↓

Timely Basis

Significant Deficiency in I.C.

↓

Deficiency / Combination — In I.C.

↓

Auditor's Prof. Judgement

↓

Suff. Important to merit

↓

Attention of TCWG

*Depends upon

- MM Actually occured
- Likelyhood Of occurance
- Potential magnitude

*Examples : Deficiency / combination — Constitutes → Sig. Deficiency

Notes to Add

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The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

(a) Deficiency in internal control – This exists when: -

   (*i*) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or

   (*ii*) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

(b) Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may, therefore, exist even though the auditor has not identified misstatements during the audit.

Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process, for example:
  - General monitoring controls (such as oversight of management).
  - Controls over the prevention and detection of fraud.
  - Controls over the selection and application of significant accounting policies.
  - Controls over significant transactions with related parties.
  - Controls over significant transactions outside the entity's normal course of business.
  - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.

Examples of indicators of significant deficiencies in internal control

- Evidence of ineffective aspects of the control environment, such as: -

Matters	Indicators
(1) Likelyhood→ in future	(1) Evidence of Deficiency → Control Env.; Mgt. Fraud; Mgt. failure→Remidial Action
(2) Susceptibility – Loss / Fraud	(2) Absence of R.A.P.
(3) Subjectivity / complexity → Estimating amount	(3) Ineffective R.A.P.
(4) FS→ amounts → exposed	(4) Misst. detected→ Not P / D / C I.C. ↓ By Audit Procedures
(5) Volume of Transaction – CoT, A/c Bal., Disclosure – Exposed To Deficiency	
(6) Cause / Frequency – Exceptions	

*Importance of controls → F.R. Process

- General Monitoring
- Controls over
  - P & D ↓ F/E
  - Selection + Application ↓ A/c Policies
  - Sig Transaction
    - R.P.
    - Outside ↓ Normal Course of Business
  - Period end F.R. process

Notes to Add

- Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
- Identification of management fraud, whether or not material, that was
- not prevented by the entity's internal control.
- Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.

- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.
- Evidence of management's inability to oversee the preparation of the financial statements.

QUESTIONS

Descriptive Questions

6. List out some matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency".

Ans. Refer to topic on "Examples of some matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency".

Notes to Add

DETERMINATION OF SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL

Auditor shall determine → Identified — One / More — Sig. Deficiencies in I.C.

↓

Basis of Audit work performed

COMMUNICATION OF SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE

Timely Basis

↑

Auditor→communicate→sig. Deficiencies in I.C.

↓ In writing

↓ Appro. Level of Mgt.

- Deficiencies
  - Communicated
  - Intends To communicate
  - TCWG → Unless inappro. To communicate directly to Mgt.
- Other Deficiencies → Not been communicated → To Mgt.→By others

Auditor → Include

- Description → of Deficiencies
- Explanation → Potential effect
- Suff. Info. → To understand context

Auditor→Explain

- Purpose of Audit → To express an opinion on F.S.
- Audit Included → Consideration of I.C. → To design Audit procedure → Not for expressing an opinion
- Matters Reported → Limited to Deficiency

The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.

If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.

The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: -

(a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and

(b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

The auditor shall include in the written communication of significant deficiencies in internal control: -

(a) A description of the deficiencies and an explanation of their potential effects; and

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication.

In particular, the auditor shall explain that:

(i) The purpose of the audit was for the auditor to express an opinion on the financial statements;

(ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and

(iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Overview of auditor's responsibilities regarding communicating deficiencies in internal control to those charged with governance and management

Checkbox	Auditor's responsibilities regarding communicating deficiencies in internal control to those charged with governance and management
✔	Determine whether, on the basis of the audit work performed, one or more deficiencies in internal control have been identified.
✔	If one or more deficiencies in internal control have been identified, determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.
✔	Communication in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis giving their description, explanation of potential effects and sufficient information to those charged with governance and management to understand context of communication.

Test Your Understanding

6. On reviewing internal control over inventories as part of statutory audit of a company, auditor finds that physical verification is not being conducted at regular intervals as stipulated by the management. The auditor finds it to be significant deficiency in internal control over inventories.

   He points it out to the management in a one-liner as under:

   "Physical verification of inventories is not being conducted at regular intervals as stipulated by management."

   Is above communication by auditor proper? Ignore statutory reporting requirements, if any in this regard.

Ans. While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication.

Therefore, the above communication is not proper. Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not carrying out physical verification of inventories at regular intervals as stipulated by management. It should explain that such a significant deficiency can lead to misstatement of inventories impacting profits of the company. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

CASE STUDY

CA. Gaurav Gogoi is about to conclude audit of a company. It has been noticed during the course of audit that there is shortage of important raw material supplies being imported from China due to prevailing geo-political situation. The company has shared with him its plan to deal with the situation. He is satisfied with assessment of the company for dealing with the matter. The issue is disclosed in financial statements and considering management's assessment, it is felt that use of going concern assumption by company in preparation of financial statements is appropriate.

Besides, he also wants to be sure that all subsequent events till now have been considered and accounted for, where ever necessary, in financial statements.

Before concluding audit, he requests written representations from management regarding its responsibilities. However, it is noticed that such written representations provided by management use qualifying language.

He has also communicated significant findings from audit in writing with those charged with governance in the company and has retained copy of relevant mails. Besides, there are certain matters which were communicated by him orally from time to time during the course of audit to those charged with governance.

QUESTIONS

Theory Questions

Based on above description, answer the following questions:

7. As regards description of matter above concerning issue of going concern, which of the following statements is most appropriate for auditor's report?

(*a*) The auditor should express an unmodified opinion.

(*b*) The auditor should express a qualified opinion as material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

(*c*) Besides expressing an unmodified opinion, the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" drawing attention to the note in which such disclosure is made in financial statements along with related matters.

(*d*) Such an issue does not affect auditor's opinion.

Ans. (*c*)

8. As regards going concern basis of accounting is concerned, which of the following statements is true?

(*a*) A company showing net loss in its financial statements is essentially not a going concern.

(*b*) Following going concern assumption of accounting is primary duty of auditor.

(*c*) In case, a company is not a going concern, its financial statements must be prepared on liquidation basis.

(*d*) Audit procedure seeking confirmation from banker regarding outstanding balance relates to verification of going concern assumption.

Ans. (*c*)

9. Which of the following statements is true in respect of auditor's responsibilities in respect of subsequent events?

(*a*) There is no obligation for an auditor to perform audit procedures for events occurring between date of financial statements and date of auditor's report.

(*b*) There is no obligation for an auditor to perform audit procedures after signing of auditor's report, even if he comes to know of an event, which if known to him earlier would have caused him to amend the audit report.

(*c*) The auditor has only to rely upon written representation of management regarding subsequent events. He has no other means to know about such events.

(*d*) The auditor should perform necessary audit procedures to know about events occurring between the date of financial statements and date of auditor's report.

Ans. (*d*)

10. As regards use of qualifying language in written representations, which of the following statement is most appropriate?

(*a*) It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

(*b*) Written representations should be unconditional. Such a wording is not acceptable.
(*c*) Such a wording dilutes intent of written representations. However, it can be accepted by auditor only in exceptional circumstances.
(*d*) Qualifying language in written representations is compulsory.

Ans. (*a*)

11. As regards auditor's responsibility regarding matters communicated orally with those charged with governance, which of following is most appropriate?

(*a*) Matters communicated orally have to be documented by the auditor stating when and to whom these were communicated.
(*b*) Matters communicated orally need not be put into writing. It is sufficient for auditor to have communicated orally.
(*c*) Matters communicated orally need not be put into writing. It is not practically feasible.
(*d*) Matters communicated orally have to be documented by the auditor stating to whom these were communicated.

Ans. (*a*)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

12. Mr. A is a statutory auditor of ABC Ltd. The branch of ABC Ltd. is audited by Mr. B, another Chartered Accountant. Mr. A requests for the photocopies of the audit documentation of Mr. B pertaining to the branch audit.

Ans. Incorrect: SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

13. When inventory under the custody and control of a third party is material to the financial statements, the auditor can obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management.

Ans. Incorrect: When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(*a*) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
(*b*) Perform inspection or other audit procedures appropriate in the circumstances.

14. When inventory under the custody and control of a third party is material to the financial statements, the auditor can obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management.

Ans. Incorrect: When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(*a*) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(*b*) Perform inspection or other audit procedures appropriate in the circumstances.

15. While auditing the books of accounts of ABC Ltd., the auditor of the company looked at the inventory counting process to obtain audit evidence. In the present case, audit procedure used by the auditor is known as "Inspection".

Ans. Incorrect: The audit procedure used by the auditor of ABC Ltd. is known as "observation". Whereas inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

16. Inquiry alone is sufficient to test the operating effectiveness of controls.

Ans. Incorrect: Inquiry along with other audit procedures (for example observation, inspection, external confirmation etc.) would only enable the auditor to test the operating effectiveness of controls. Inquiry alone is not sufficient to test the operating effectiveness of controls.

Theory Questions

17. While conducting the audit of Pummy Limited, the statutory auditors collected written representations from the Management. The audit was finalized in addition to other audit procedures but, without making any inquiries, as the statutory auditors were short of time. In the light of this information, state the importance of inquiry as one of the methods of collecting Audit Evidence.

Ans. Inquiry: As per SA 500 Audit Evidence: -

(*i*) Inquiry consists of seeking information of knowledgeable persons, financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

(*ii*) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

(*iii*) Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

(*iv*) In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

18. "When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences" Explain.

Ans. SA 330, "The Auditor's Responses to Assessed Risks" requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgement. SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgement regarding whether sufficient appropriate audit evidence has been obtained.

In order to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate.

19. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. Explain.

Ans. Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige. He needs evidence to obtain information for arriving at his judgement.

SA 500 – "Audit Evidence", explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

❑❑❑

CHAPTER 8 Audit Report

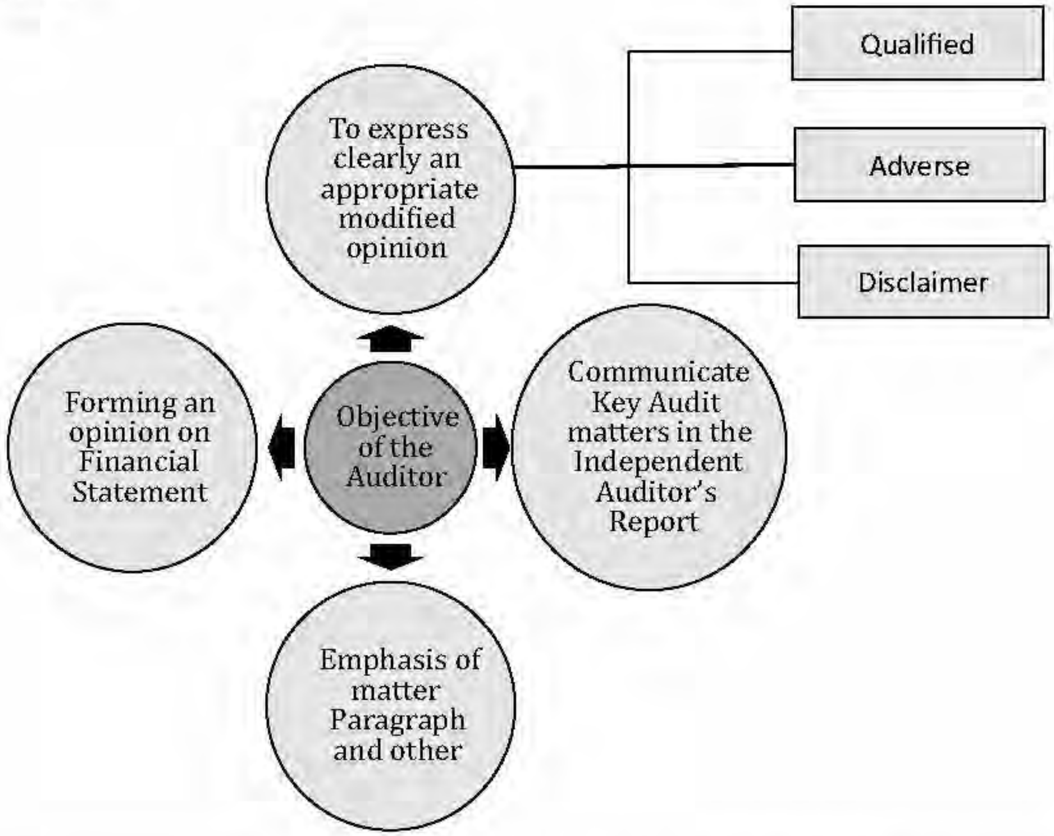
S. No.	Sub Topics	Easy	Moderate	Hard
01.	Forming an Opinion on the Financial Statements-Objective of the Auditor			
02.	Objectives of the Auditor			
03.	To form Opinion - Auditor to obtain Reasonable Assurance			
04.	Evaluations by the Auditor			
05.	Specific Evaluations by the Auditor			
06.	Definitions			
07.	Form of Opinion			
08.	Auditor's Report			
09.	Auditor's Report for Audits Conducted in Accordance with Standards on Auditing			
10.	Auditor's Report Prescribed by Law or Regulation			
11.	Modifications to the Opinion in the Independent Auditor's Report			
12.	Circumstances when a Modification to the Auditor's Opinion is Required			
13.	Objective of the Auditor - To Express Clearly an Appropriately modified Opinion			
14.	Types of Modified Opinions			
15.	Which type of opinion is appropriate?			
16.	Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement			
17.	Form and Content of the Auditor's Report When the Opinion is Modified			
18.	Basis for Opinion			
19.	Description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements			

20.	Considerations When the Auditor Disclaims an Opinion on the Financial Statements			
21.	Communication with Those Charged with Governance			
22.	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report			
23.	Objective of the Auditor as per SA 706			
24.	Emphasis of Matter Paragraphs in the Auditor's Report			
25.	The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion			
26.	Other Matter Paragraphs in the Auditor's Report			
27.	Communication with Those Charged with Governance			
28.	Communicating Key Audit Matters in the Independent Auditor's Report			
29.	Purpose of Communicating Key Audit Matters			
30.	Objectives of the Auditor regarding Key Audit Matters			
31.	Determining Key Audit Matters			
32.	Communicating Key Audit Matters			
33.	Communicating Key Audit Matter- not a substitute for disclosure in the Financial Statements etc			
34.	Communication with Those Charged with Governance			
35.	Standard on Auditing (SA) 710, "Comparative Information- Corresponding Figures and Comparative Financial Statements"			
36.	The Nature of the Comparative Information			
37.	Audit Reporting Regarding Corresponding Figures			
38.	Comparative Financial Statements			
39.	Audit of Branch Office Accounts			
40.	Joint Audit			
41.	Reporting Requirements under The Companies Act, 2013			
42.	Reporting under Companies Auditor's Report Order,2020 [CARO, 2020]			

Notes to Add

Notes to Add

OVERVIEW



Notes to Add

Audit process culminates in formation of opinion by an auditor and expression of the same by means of audit report. Audit report, therefore, is the final outcome of an audit exercise. It is the document on which reliance is placed by users of financial statements as it contains auditor's opinion. Audit evidence obtained by performing various audit procedures, ultimately, leads to crystallization of opinion by auditor contained in audit report.

Understanding enormous significance of audit report, Sameer was unequivocal in his mind regarding some kind of consistency and comparability in reporting. It logically led him to next question- What are basic elements of an audit report? How does it look like? Is it necessary for an auditor to prepare audit report using these elements?

A counter question struck his mind in no time. If there is consistency and comparability in reporting, how does an auditor report in specific situations?

Shouldn't there be flexibility in reporting in particular situations? How do auditors do that? If an auditor wants to highlight some matters which are necessary to understanding of users of financial statements, how the same can be ensured?

And what about those issues which were identified as significant issues during the audit? Can such issues and manner of addressing such issues be reported? What kind of audit procedures were performed on those significant matters? There must be some sort of reporting mechanism for these issues. In absence of such type of flexibility in reporting, audit report can become too mechanical. He was mulling deeply.

What if auditor wants to express a modified opinion? What are different types of it and under what circumstances different types of modified opinion can be given by auditor? Does auditor have to state basis for such an opinion compulsorily? These were probing thoughts criss-crossing his mind.

He was also considering about reporting requirements if some matters are specifically required to be reported in accordance with law. Particularly, in case of companies, are there some specific matters? How reporting is to be made by auditor in respect of such matters?

Amidst this maze of thoughts, Shekhar called him to inform that, audit of company his team was doing, is now over and audit report has been issued. Wanting to know about outcome, he was asked by Shekhar to go to website of the company and go through audit report himself.

INTRODUCTION

Management is responsible for the preparation of the financial statements. Management also accepts responsibility for necessary internal controls to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor as to whether the financial statements exhibit a true and fair view of the affairs of the entity.

Thus, an audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and fair representation of the transactions they claim to represent.

This involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements. The main users of audit report are shareholders, members and all other stakeholders of the company.

FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

↓

Auditor's Responsibility

- To form an Opinion on F.S.
- From / Content — Audit Report

Notes to Add

OBJECTIVE OF THE AUDITOR

(1) Forming an opinion on F.S. → Based on → Evaluation of → conclusion
↓
Drawn from
↓
Audit Evidence (AE)
↓
In application Financial Reporting Framework (app F.R.F.)

(2) Expressing clearly → that opinion →Written Report

TO FORM OPINION –AUDITOR TO OBTAIN REASONABLE ASSURANCE

To form opinion → Auditor to obtain → Reasonable Assurance (RA) → Whether F.S. are free material misstatement → Due to → Fraud/Error

(*i*) Sufficient & appropriate A.E. obtained

(*ii*) Uncorrected Misstatement → Material → Individually → Aggregate

(*iii*) Evaluation

Notes to Add

SA 700 (Revised): "Forming an Opinion and Reporting on Financial Statements", deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.

The requirements of this SA are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This SA promotes consistency in the auditor's report, but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions.

Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

The objectives of the auditor as per SA 700 (Revised) are:

- To form an opinion on the financial statement based on an evaluation of the conclusion drawn from the audit evidence
- To express clearly that opinion through a written report.

Notes to Add

....

....

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

(*a*) Whether sufficient appropriate audit evidence has been obtained;

(*b*) Whether uncorrected misstatements are material, individually or in aggregate;

(*c*) The evaluations.

Notes to Add

....

....

....

QUESTIONS

Theory Questions

1. "The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework." Explain

Ans. The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

(*a*) Whether sufficient appropriate audit evidence has been obtained;

(*b*) Whether uncorrected misstatements are material, individually or in aggregate;

(*c*) The evaluations.

Evaluations by the Auditor

(1) FS as per FRF

(2) Qualitative aspects of Entity

(*a*) Accounting practice

(*i*) SA 260

(*ii*) Communication with TCWG

(*b*) Any management's Bias in Judgement

(*i*) SA540

(*ii*) Accounting Estimate, Related Disclosure

2. "The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements." Discuss stating clearly qualitative aspects of the entity's accounting practices.

Ans. Qualitative Aspects of the Entity's Accounting Practices are as follows:-

1. Management makes a number of judgements about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:

   (*i*) The selective correction of misstatements brought to management's attention during the audit.

   (*ii*) Possible management bias in the making of accounting estimates.
4. SA 540 addresses possible management bias in making accounting estimates.

3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required.

Ans. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:

(*i*) The selective correction of misstatements brought to management's attention during the audit.

Example:

- Correcting misstatements with the effect of increasing reported earnings, but not correcing misstatements that have the effect of decreasing reported earnings.
- The combination of several deficiencies affecting the same significant account or disclsure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgement and involvement of audit
- Executives.

(*ii*) Possible management bias in the making of accounting estimates.

Notes to Add

QUALITATIVE ASPECTS OF THE ENTITY'S ACCOUNTING PRACTICES

(i) Mgt. Judgement → [Amounts / Disclosures] → FS

(ii) Discussion → Qualitative Aspects → A/c pratices

(iii) *Possible bias → Mgt. Judgements

*Lack of Neutrality → Indicators → [Selective correction of Misst. / Possible Mgt. Bias → A/c Estimate]

*Effect of uncorrected Misst.

(iv) Possible Mgt. Bias → A/c estimate

↓

Indicators → Do not constitute Misst. → For purpose of Drawing conclusion → On reasonableness of Individual A/c Estimate

↓

Affect Auditor's Evaluation

↓

FS as a whole are Free from MM

Notes to Add

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

(1) Qualitative Aspects of the Entity's Accounting Practices

(*a*) Management makes a number of judgements about the amounts and disclosures in the financial statements.

(*b*) SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.

(*c*) In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that the cumulative effect of lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality include the following:

(*i*) The selective correction of misstatements brought to management's attention during the audit.

Example: Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.

(*ii*) Possible management bias in the making of accounting estimates.

(*d*) SA 540 addresses possible management bias in making accounting estimates. Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

Notes to Add

SPECIFIC EVALUATIONS BY THE AUDITOR

Specific Evaluation

(1) FS → Disclose → Significant Accounting Policies → Selected → app F.R.F → Applied

(2) Accounting Estimate → Made by Mgt. → Reasonable

(3) Info. In F.S.

- (*a*) Relevant
- (*b*) Reliable
- (*c*) Comparable
- (*d*) Understandable

(4) F.S → Adequate Disclosure?

(5) Terminologies → Appropriate?

*** When F.S. are prepared → as per → Fair presentation Framework**

Evaluation (1.3) | **Specific Evaluation (1.4)**

To also include consideration

- **Overall**
  - **Presentation** | **Structure** | **Content**
  - **F.S.**
- **F.S. + Related notes**
  - ↓ **Represent**
  - ↓ **underlying**
  - **Transaction** | **Event**

Notes to Add

In particular, the auditor shall evaluate whether:

(*a*) The financial statements adequately disclose the significant accounting policies selected and applied;

(*b*) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(*c*) The accounting estimates made by management are reasonable;

(*d*) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

(*e*) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(*f*) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Further, when the financial statements are prepared in accordance with a fair presentation framework, the evaluation mentioned above (Paragraph 1.3 & 1.4) shall also include an evaluation by the auditor as to whether the financial statements achieve fair presentation which shall include consideration of:

(*a*) The overall presentation, structure and content of the financial statements; and

(*b*) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

An overview of specific evaluations by the auditor

Checkbox	Specific evaluations by the auditor
✔	Selected and applied significant accounting policies are adequately disclosed.
✔	Accounting policies are consistent with applicable financial reporting framework.
✔	Accounting estimates by management are reasonable.
✔	Information in financial statement is relevant, reliable, comparable and understandable.
✔	Disclosures in financial statements are adequate to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.
✔	Terminology used in financial statements is appropriate.

Notes to Add

QUESTIONS

Theory Questions

4. "An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations.

Ans. Specific Evaluations by the auditor: In particular, the auditor shall evaluate whether :

(*i*) The financial statements adequately disclose the significant accounting policies selected and applied;

(*ii*) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(*iii*) The accounting estimates made by management are reasonable;

(*iv*) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

(*v*) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(*vi*) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

DEFINITIONS

For making the understanding better, the following terms have been defined below:

(a) General purpose financial statements: Financial statements prepared in accordance with a general purpose framework.

(b) General purpose framework: A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(*i*) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(*ii*) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

(c) Unmodified opinion: The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Notes to Add

FORM OF OPINION

(1) Unmodified

  (*a*) Auditor concludes → F.S. → as per App. F.R.F.

(2) Modified (SA 705)

  (*a*) F.S.

    (*i*) Not free from MM

    (*ii*) as per A.E. obtained

  (*b*) Unable to obtain

    (*i*) Suff. & Appro A.E.

Notes to Add

Unmodified Opinion: The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Modified Opinion: If the auditor:

(*a*) Concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement ; or

(*b*) Is unable to obtain sufficient appropriate audit evidence to conclude that the financial statement as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

Notes to Add

AUDITOR'S REPORT

↓

Specific Heading

(i) Title → "Independent Auditor's Report"

(ii) Addressee → Law / Regulations / Terms of engagement — Specify → To whom
↓
Auditor's Report is to be Addressed

(iii) Auditor's Opinion ⟷ Heading + Also include

- Identify Entity ↓ NAME
- State ↓ F.S. ↓ Audited
- Identify ↓ Title of each st.
- Refer
  - Notes
  - Sig. A/c Policies
- Specify
  - Date
  - Pd. Covered

(iv) Basis for Opinion→Heading

- State ↓ Audit ↓ Conducted ↓ As per SA
- Refer ↓ Section ↓ Describe Auditor's Responsibility
- Statement ↓ Auditor
  - Independent of Entity
  - Fulfilled Ethical Responsibilities
- State ↓ A.E. ↓ Stuff + Appro.

(v) Going Concern → SA570

(*a*) F.S.→ Assumption→ Entity
- G.C.
- Continue Operation ↓ Forseeable future

(*b*) Entity
- Realise→Assets
- Discharge→Liabilities

(*c*) Appro.→ Mgt. use of G.C.

(*d*) Event
Condition
— Sig. Doubt→Entity's ability to continue as G.C.

(*e*) Disclosure ↕ Nature + Implication ↕ Material Uncertainity

In case of

Fair Presentation F.R.F. ↓ Fair Presentation F.S.

Compliance Framework ↓ F.S. not misleading

(vi) Key Audit Matters → SA 701 — Listed / Other — Entities

Other ↓ Required — Law / Regulation

(vii) Mgt. Responsibilities

- Prepare F.S. → app. F.R.F.
- I.C.
- Assess G.C.

(viii) Auditor's Responsibilities → State

- Objective of Auditor
- R.A. = High Assurance ≠ Guarantee
- Misst. Arise from — F / E

\+

(A) Exercises → Prof Judgement
Maintains → Prof. Skepticism

(B)
Identify + Assess → RoMM
Understand → I.C.
Evaluate → A/c Policies
Conclude → Mgt.'s use of G.C.
Evaluate — Presentation / Structure / Content — F.S.

(C) Describe → Group Audit Responsibilities

(ix) Location of Description of Auditor's Responsibilities

- Within ↓ Body of Audit Report
- Within ↓ An Appendix to Audit Report
- Description ↓ Of website

(x) Other Reporting Req. → Eg. CARO, 2020

(xi) Signature → proprietor ↓ Personal Name

Firm ↓ Personal Name (Eng. Partner) + Name of Audit Firm

\+ ICAI Membership No.

\+ ICAI F.R.N.

\+ UDIN

(xii) Place of Signature → Specific Location

(xiii) Date of Auditor's Report → Not earlier than

↓

The date when Auditor Obtains Stuff + Appro. AE

*UDIN

→ To crub malpractices

→ Professional Development Committee of ICAI

→ Phased Manner

→ Mandatory → 1 Feb 2019

→ CA → Full Time COP only

→ 18 Digit → Alphanumeric

- First 2 Digits → Last 2 Digits of C.Y.
- Next 6 Digits → ICAI Membership No.
- Last 10 Digits → Random Alpha – Numeric

The auditor's report shall be in writing. This SA- 700 requires the use of specific headings, which are intended to assist in making auditor's report more recognizable, where audit is conducted in accordance with the relevant Standards on Auditing.

AUDITOR'S REPORT FOR AUDITS CONDUCTED IN ACCORDANCE WITH STANDARDS ON AUDITING

- Title
- Addresses
- Auditor's Opinion
- Basis for Opinion
- Goining Concern
- Key Audit Matters
- Responsibilities for the Financial Statements
- Auditor's Responsibilities for the Audit of the Financial Statements
- Location of the description of the auditor's responsibilities
- Other Reporting Responsibilities
- Signature of the Auditor
- Place of Signature
- Date of the Auditor's Report

Basic Elements of an Audit Report are given below:

1. **Title:** The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.

   For example, "Independent Auditor's Report," distinguishes the independent auditor's report from reports issued by others.
2. **Addressee:** The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed.

The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited. In case of a company, the report is addressed to the shareholders of the company.

Illustration 1: M/s Smart & Associates are the statutory auditors of Hot meals Ltd. for the FY 2021-22. How will the auditor address the audit report issued on the financial statements for the FY 2021-22? Also give a title to the report.

Solution: INDEPENDENT AUDITOR'S REPORT

To the Members of Hot meals Ltd.

Illustration 2: Richa International is a partnership firm dealing in export of blankets. The partners of the firm are Richa and Ashish. Explain how the statutory auditor of the firm will address the auditor's report.

Solution: INDEPENDENT AUDITOR'S REPORT

To the Partners of Richa International

3. Auditor's Opinion: The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."
   - The Opinion section of the auditor's report shall also:
   - Identify the entity whose financial statements have been audited;
   - State that the financial statements have been audited;
   - Identify the title of each statement comprising the financial statements;
   - Refer to the notes, including the summary of significant accounting policies; and
   - Specify the date of, or period covered by, each financial statement comprising the financial statements.

Unmodified Opinion

When expressing an unmodified opinion on financial statements, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

(a) In our opinion, the accompanying financial statements present fairly, in all material respects, [...] in accordance with [the applicable financial reporting framework]; or

(b) In our opinion, the accompanying financial statements give a true and fair view of [...] in accordance with [the applicable financial reporting framework].

The phrases "present fairly, in all material respects," and "give a true and fair view" are regarded as being equivalent

When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

Illustration 3: M/s Amitabh & Associates are the statutory auditors of Ringston Ltd. which is a company engaged in the business of manufacture of pen drives. The auditor has started drafting the audit report for the FY 2021-22. CA Amitabh, the engagement partner is of the view that the financial statements of Ringston Ltd. represent a true and fair view. Give the draft of the opinion paragraph of the audit report.

Solution:

Opinion

We have audited the financial statements of Ringston Limited which comprise the Balance Sheet as at 31.03.2022 and the statement of Profit and Loss Account and the notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the company as at 31.03.2022 and the Profit & Loss for the year ending on that date.

4. **Basis for Opinion:** The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

a. States that the audit was conducted in accordance with Standards on Auditing;

b. Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;

c. Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

d. States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Thus, the Basis for opinion section provides important context about the auditor's opinion.

Illustration 4: M/s Kite Rite & Associates are the statutory auditors of Prime Deluxe Limited, for the FY 2021-22. At the time of finalising the audit report, one of the engagement team members, Mr. Robin, asked the engagement partner, CA Kite as to what all should be included in the Basis of Opinion Paragraph. The engagement partner CA Kite, explained the team in detail and asked Mr. Robin to draft such section for the auditor's report of Prime Deluxe Limited. Help Mr. Robin to draft the Basis for opinion section.

Solution: We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

5. **Going Concern:** Where applicable, the auditor shall report in accordance with SA 570 (Revised).
   - Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.
   - When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.
   - The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.
   - Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgement, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.
   - A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgement, appropriate disclosure of the nature and implications of the uncertainty is necessary for:

(a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or

(b) In the case of a compliance framework, the financial statements not to be misleading.

6. **Key Audit Matters:** For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with SA 701.

   When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701.

   Example: Entities characterized in such law or regulation as public interest entities.

   The auditor may also decide to communicate key audit matters for other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business.

   Example: Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charitable institutions.

7. **Responsibilities for the Financial Statements:** The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

   (a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

   (b) Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern.

   (c) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; [because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and

   (d) Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

SA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.

Oversight of the financial reporting process: This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from Management. In this case, the heading of this section shall also refer to "Those Charged with Governance" **or such term that is appropriate in the context of the legal framework applicable to the entity.**

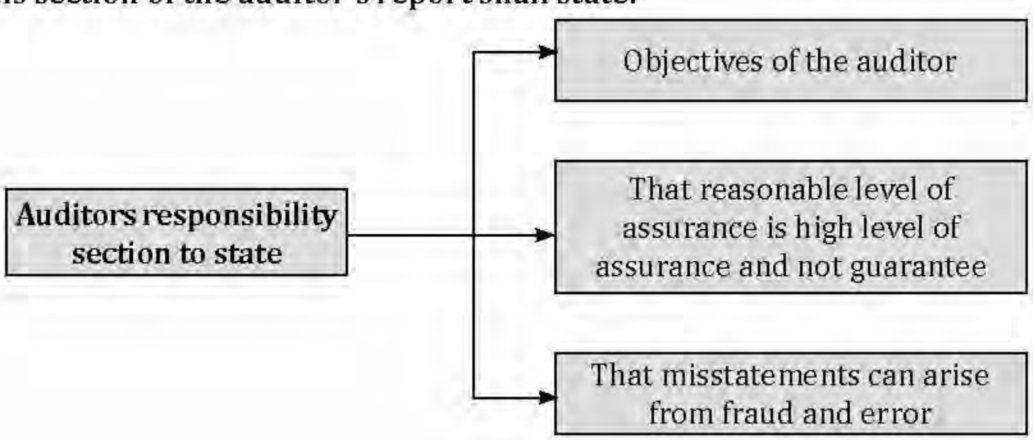
Illustration 5: Diamond Shine Ltd. is a company engaged in the manufacture of detergent. M/s Bright & Associates are the statutory auditors of the company. Explain how the paragraph related to the management's responsibility will come in the auditor's report.

Solution: Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity) and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error. In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so. Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

8. **Auditor's Responsibilities for the Audit of the Financial Statements:** The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."

   I. **This section of the auditor's report shall state:**



(a) That the objectives of the auditor are to:

(*i*) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and

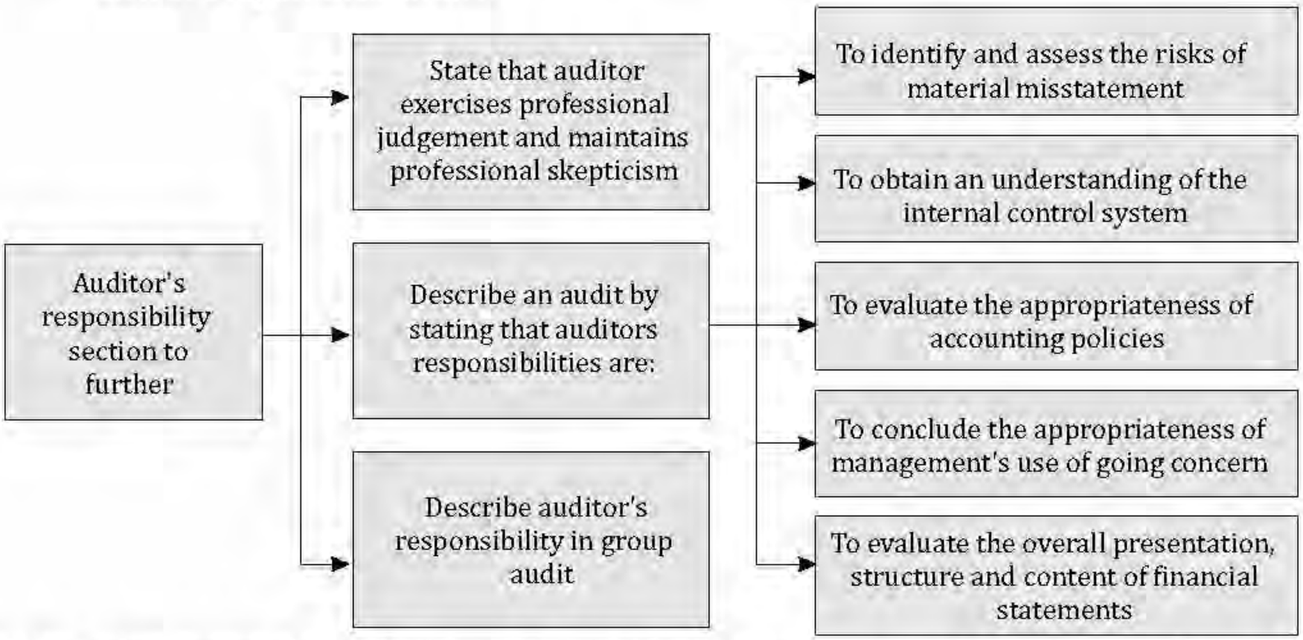
(*ii*) Issue an auditor's report that includes the auditor's opinion.

(b) That reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and

(c) That misstatements can arise from fraud or error, and either:

(*i*) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or

(*ii*) The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:



(a) State that, as part of an audit in accordance with SAs, the auditor exercises professional judgement and maintains professional skepticism throughout the audit; and

(b) Describe an audit by stating that the auditor's responsibilities are:

(*i*) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

(*ii*) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances.

(*iii*) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

(*iv*) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

(v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

(c) When SA 600 applies, further describe the auditor's responsibilities in a group audit engagement by stating:

The division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components is audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions /branches/ subsidiaries or other components audited by other auditors.

(II) The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:

(a) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;

(b) For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and

(c) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with SA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure.

9. Location of the description of the auditor's responsibilities for the audit of the financial statements: The description of the auditor's responsibilities for the audit of the financial statements shall be included:

With the body of the auditor's report

Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix or

By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

Illustration 6: M/s Ajay Vijay & Associates are the statutory auditors of Sarovar Ltd. for the FY 2021-22. The company is engaged in the business of manufacture of water bottles. At the time of finalizing the auditor's report, one of the audit team members asked CA Ajay, the engagement partner to advise as to how the auditor's responsibilities can be shown in an appendix to the auditor's report. Draft the auditor's responsibility paragraph so as to advise the audit team member.

Solution: Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at [indicate page number or other specific reference to the location of the description], forms part of our auditor's report.

10. **Other Reporting Responsibilities:**
    - If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled
    - **"Report on Other Legal and Regulatory Requirements"** or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs.
    - If other reporting responsibilities are presented in the same section as the related report elements required by the SAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs.
    - If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements stated above shall be included under a section with a heading "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements."

11. **Signature of the Auditor:** The auditor's report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm.

    The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

12. **Place of Signature:** The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

13. **Date of the Auditor's Report:** The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:
    - All the statements that comprise the financial statements, including the related notes, have been prepared; and
    - Those with the recognized authority have asserted that they have taken responsibility for those financial statements

The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in SA 560.

UDIN

It was noticed that financial documents/ certificates attested by third person misrepresenting themselves as CA Members were misleading the Authorities and Stakeholders. ICAI also received number of complaints of signatures of CAs being forged by non CAs. To curb the malpractices, the Professional Development Committee of ICAI implemented in phased manner an innovative concept of UDIN i.e. Unique Document Identification Number. All Certificates were made mandatory with effect from 1st February, 2019 as per the Council decision taken at its 379th Meeting held on 17th – 18th December, 2018.

Chartered Accountants having full-time Certificate of Practice can register on UDIN Portal and generate UDIN by registering the certificates attested/certified by them.

Accordingly, an auditor is required to mention the UDIN with respect to each audit report being signed by him, along with his membership number while signing an audit report. The same is shown in the below illustration.

Illustration 7:

M/s TUV & Associates are the statutory auditors of Venus Ltd. for the FY 2021-22.

The following is the correct way of signing an audit report.

M/s TUV & Associates
Chartered Accountants
(Firm's Registration No.)
Signature
(Name of the Member Signing the Audit Report)
(Designation) (Membership No. XXXXX)

Place of Signature: UDIN: 20037320AAAAAH1111

Date:

Test Your Understanding

1. Maithili Thakur, a CA student, was perusing audit report of a company. Her eyes fell on an 18-digit alpha numeric number stated at end of audit report below the signatures of auditor and membership number. Make her understand objective and significance of such a randomly generated number. Is it required to be stated in case of audit reports only?

Ans. The 18-digit alpha numeric number noticed by her at end of audit report is Unique Document Identification number (UDIN). It is a system generated unique number. Its basic objective is to curb the malpractices of non-CAs impersonating themselves as CAs. It helps in securing reports and documents issued by practising CAs.

It is required to be stated in case of audit reports and certificates.

2. CA. Maya Memani has conducted audit of a company. She has asked Sana, a CA student undergoing training in her office, to prepare draft audit report. Sana was part of engagement team conducting the audit. She has been further told to prepare draft report expressing unmodified opinion. After drafting para comprising unmodified opinion, Sana feels no need to provide basis for opinion. Discuss why her thinking is not proper.

Ans. "Basis for Opinion" is one of basic elements of an audit report in accordance with SA-700. Even in cases where unmodified opinion is expressed by auditor, "Basis for opinion" has to be provided by auditor. Basis for opinion section provides context about auditor's opinion.

Therefore, Sana's thinking is not proper.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

5. There is no need of addressee in the Auditor's report.

Ans. Incorrect: The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

6. Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements.

Ans. Incorrect: Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.

7. Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.

Ans. Incorrect: Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised).

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5. Where applicable
6. Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

Theory Questions

8. The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section.

Ans. The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also:

(*a*) Identify the entity whose financial statements have been audited;

(*b*) State that the financial statements have been audited;

(*c*) Identify the title of each statement comprising the financial statements;

(*d*) Refer to the notes, including the summary of significant accounting policies; and

(*e*) Specify the date of, or period covered by, each financial statement comprising the financial statements.

9. The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain

OR

Give a brief description about the management responsibility to be mentioned in the statutory auditor's report.

Ans. Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

This section of the auditor's report shall describe management's responsibility for:

(*a*) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; [because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and (*b*) Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

10. The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.

Ans. Basis for Opinion: The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

(*a*) States that the audit was conducted in accordance with Standards on Auditing;

(*b*) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;

(*c*) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

(*d*) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Notes to Add

Notes to Add

AUDITOR'S REPORT PRESCRIBED BY LAW OR REGULATION

Requirement

Legal/Regulatory ← Difference → SA

Specific
↓
Refer SA only IF
13 point present
↓
Otherwise → Law/Reg. Req.

Only → Layout / Wordings
↓
13 points
↓
MINIMUM REQ.

Notes to Add

SA 200 explains that the auditor may be required to comply with legal or regulatory requirements in addition to SAs. When the differences between the legal or regulatory requirements and SAs relate only to the layout and wording of the auditor's report, the requirements stated below in points (a)-(m) set out the minimum elements to be included in the auditor's report to enable a reference to the Standards on Auditing. In those circumstances, the requirements stated in paragraph 3.1 above that are not included in points (a)–(m) need not be applied.

For example, the required ordering of the Opinion and the Basis of Opinion sections need not be applied.

Where specific requirements in a particular law or regulation do not conflict with SAs, the layout and wording required by this SA assist users of the auditor's report in more readily recognizing the auditor's report as a report of an audit conducted in accordance with SAs.

If the auditor is required by law or regulation to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements:

(a) A title.

(b) An addressee, as required by the circumstances of the engagement.

(c) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements.

(d) An identification of the entity's financial statements that have been audited.

(e) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI.

(f) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements relating to going concern as per SA 570 (Revised).

(g) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements relating to going concern as per SA 570 (Revised).

(h) Where applicable, a section that includes the information required by SA 701, or additional information about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that SA.

(i) A description of management's responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements as contained in this SA 700.

(j) A reference to Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements as contained in this SA 700.

(k) The auditor's signature.

(l) The Place of signature.

(m) The date of the auditor's report.

Illustration 8: Auditor's Report on Financial Statements of a Listed Entity Prepared in Accordance with a Fair Presentation Framework

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company (registered under the Companies Act, 2013) using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the accounting Standards prescribed under section 133 of the Companies Act, 2013.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit comprise the Code of Ethics issued by ICAI together with the other relevant ethical requirements relating to the audit and the auditor refers to both.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other
- Reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements[1]

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (statement of changes in equity)[2] and statement of cash flows for the year then ended, and notes to the financial statements, including.

a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)][3].

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (changes in equity)[4] and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SA 701.]

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity)[5] and cash flows of the Company in accordance with[6] the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act.

This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate implementation and maintenance of accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or applicable auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. Under section 143(3)(i) of the Companies Act, 2013, we are also responsible for expressing our opinion on whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Other Matter

We did not audit the financial statements/ information of _______ (number) branches included in the stand alone financial statements of the Company whose financial statements/financial information reflect total assets of ₹ _________ as at 31st March 20XX and the total revenue of ₹ _________ for the year ended on that date, as considered in the standalone financial statements / information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of these matters.

Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2020 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

[For detailed discussion on CARO 2020, refer Chapter 10, The Company Audit] As required by Section 143(3) of the Act, we report that:

(*a*) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.

(*b*) In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from the branches not visited by us[7]]

(*c*) [The reports on the accounts of the branch offices of the Company audited under Section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report[8].]

(*d*) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from the branches not visited by us[9]].

(*e*) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.

(*f*) We do not have any observation or comment on the financial statements or matters which have any adverse effect on the functioning of the company.

(*g*) On the basis of the written representations received from the directors as on 31st March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.

(*h*) We do not have any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected herewith.

(*i*) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".

(*j*) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:

(1) The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer Note XX to the financial statements; [or the Company does not have any pending litigations which would impact its financial position[10]]

(2) The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long- term contracts including derivative contracts – Refer Note XX to the financial statements; [or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.[11]]

(3) There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company {or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company[12]}.

(4)

(*i*) The management has represented that, to the best of its 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*) The management has represented, that, to the best of its 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 we have considered reasonable and appropriate in the circumstances, nothing has come to our notice that has caused us to believe that the representations under sub-clause (*i*) and (*ii*) contain any material mis-statement.

(5) The dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

(6) The company 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.

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)
Signature
(Name of the Member Signing the Audit Report)
(Designation[13])
(Membership No. XXXXX)
UDIN: 20037320AAAAAH1111
Place of Signature:

Date:

Notes to Add

MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

↓

Deals with Auditor's Responsibility

↓

To issue an appro. Audit Report

↓

In circumstances when → Modification is necessary

- Audit Report
  - Unmodified Report
  - Modified Report
    - Emphasis of Matter — Other Matter
    - Modified Opinion — Qualified Opinion — Adverse Opinion — Disclaimer of Opinion

Audit Report

- Unmodified Report
- Modified report
  - Emphasis of matter
    - Other matter
  - Modified opinion
    - Qualified opinion
    - Adverse opinion
    - Disclaimer of opinion

> This SA also deals with how the form and content of the auditor's report is affected when the auditor expresses a modified opinion.

Notes to Add

Standard on Auditing (SA) 705 "Modifications to the Opinion in the Independent Auditor's Report" deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised) "Forming an Opinion and Reporting on Financial Statements", the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

Notes to Add

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

11. The auditor shall modify the opinion in the auditor's report only when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

Ans. Incorrect: The auditor shall modify the opinion in the auditor's report when:

(*a*) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(*b*) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Theory Questions

12. Discuss the objective of the auditor as per Standard on Auditing (SA) 705 "Modifications to The Opinion in The Independent Auditor's Report"

Ans. As per Standard on Auditing (SA) 705 "Modifications To The Opinion In The Independent Auditor's Report", the objective of the a uditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

(*a*) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

(*b*) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

CIRCUMSTANCES WHEN A MODIFICATION TO THE AUDITOR'S OPINION IS REQUIRED

The Auditor concludes

↓

Based on

- A.E. obtained
  ↓
  F.S. as a whole are NOT FREE
  ↓
  From MM
- Unable to obtain
  ↓
  Suff. + Appro. A.E.
  ↓
  F.S. as a whole ARE FREE
  ↓
  From MM

OBJECTIVE OF THE AUDITOR-TO EXPRESS CLEARLY AN APPROPRIATELY MODIFIED OPINION

↓

The Auditor concludes

↓

Based on

- A.E. obtained
  ↓
  F.S. as a whole are NOT FREE
  ↓
  From MM
- Unable to obtain
  ↓
  Suff. + Appro. A.E.
  ↓
  F.S. as a whole ARE FREE
  ↓
  From MM

Notes to Add

....

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....

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The auditor shall modify the opinion in the auditor's report in the following circumstances:

- he auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Notes to Add

As per Standard on Auditing (SA) 705 "Modifications To The Opinion In The Independent Auditor's Report", the objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

(a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Notes to Add

Notes to Add

TYPES OF MODIFIED OPINIONS

Misstatement → Material	Suff. & Appro. A.E.	
	Obtained	Unable to Obtain
But not pervasive	Qualified opinion	Qualified opinion
And pervasive	Adverse opinion	Disclaimer of Opinion

→ Pervasive — Effect / Possible Effect — Misst. → on FS.

- Not confined
- Confined ↓ Substantial proportion
- Related to ↓ Fundamental Disclosures

Auditor → Having Obtained → Unable to obtain → Suff. + Appro. A.E. → Concludes that → Misstatement → Individually → Aggregate

- Material But Not Pervasive ↓ Qualified Opinion
- Material and Pervasive ↓ Adverse Opinion

(A.E. obtained)

- Material and Pervasive ↓ Disclaimer of Opinion
- Material But Not Pervasive ↓ Qualified Opinion

(A.E. Not obtained)

There are three types of modified opinions, namely-

(1) A qualified opinion

(2) An adverse opinion

(3) A disclaimer of opinion

Qualified Opinion	The auditor, having obtained sufficient appropriate audit evidence concludes that misstatements, are material, but not pervasive or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetached misstatements if any, could be material but not pervasive.

Adverse Opinion	The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, conclude that misstatements individually or in the aggregate are both material and pervasive to the financial statements.
Disclaimer of Opinion	The auditor shall disclaim an opinion when he is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and he conclude that the possible effects on the financial statements of undetached misstatements, if any could be both material and pervasive.

Qualified Opinion

The auditor shall express a qualified opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

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

Illustration 9: Super Duper Ltd. is a company engaged in the manufacture of office furniture. M/s Young Old & Associates are the statutory auditors of the company for the FY 2021-22. During the year under audit, the engagement partner CA Young noticed that the company has not bifurcated its loans into long term and short term. CA Young understands that such misstatement is not pervasive though the same is material.

Explain the type of opinion that should be given by M/s Young Old & Associates in this case.

Solution: M/s Young Old & Associates should give a qualified opinion as the effect of the misstatement on account of the non-bifurcation of loans into long term and short term loans, is material but not pervasive.

Adverse Opinion

The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Definition of Pervasive: A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that, in the auditor's judgement:

(*i*) Are not confined to specific elements, accounts or items of the financial statements;

(*ii*) If so confined, represent or could represent a substantial proportion of the financial statements; or

(*iii*) In relation to disclosures, are fundamental to users' understanding of the financial statements.

Illustration 10: M/s Taj Raj & Associates are the statutory auditors of Polex Ltd. engaged in the manufacture of premium watches, for the FY 2021-22. During the course of audit, CA Taj, the engagement partner found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Both the facts are not reflected in the financial statements for the year ending 31.03.2022. Accordingly, CA Taj is of the view that the impact of both the situations on the financial statements is material and pervasive and thus, the financial statements represent a distorted view of the state of affairs of the company. Explain the reporting requirements of CA Taj.

Solution: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

In the case Polex Ltd., CA Taj found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Such situations are not reflected in the financial statements of the company despite having a material and pervasive impact on the financial statements. As such, CA Taj should give an adverse opinion.

Further, CA Taj should also consider the reporting responsibilities under CARO 2020 and section 143(12) of the Companies Act, 2013.

Disclaimer of Opinion The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

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

Illustration 11: Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2021-22 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. Explain the kind of audit report that the statutory auditor of the company should issue in this case.

Solution: When the statutory auditor of the company is unable to obtain sufficient and appropriate audit evidence, the auditor should give disclaimer of opinion as per SA 705.

In the present case, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit. Also, such data and reports are not available manually. As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.

Notes to Add

WHICH TYPE OF OPINION IS APPROPRIATE?

Appropriateness of opinion → Depends Upon

- Nature of Matter
  - F.S are Materially Misstated
  - F.S. May be materially Misstated → In are of inability to obtain Suff. + Appro A.E.
- Auditor Judgement about Pervasiveness

Notes to Add

The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The table below illustrates how the auditor's judgement about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	Auditor's Judgement about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but not Pervasive	Material and Pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

13. The auditor shall express a qualified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Ans. Incorrect: The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

14. The auditor shall express a disclaimer of opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Ans. Incorrect: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

15. When the auditor has to express an adverse opinion, he need not communicate with those charged with governance as this may have an impact on payment of his audit fees.

Ans. Incorrect: When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification.

Theory Questions

16. Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion.

Ans. An auditor shall express an adverse opinion, when the auditor having obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in aggregate are both material and pervasive.

Whereas, when the auditor, having obtained sufficient and appropriate audit evidence, concludes that misstatements are material but not pervasive, shall express a qualified opinion.

SA705 – "Modifications To The Opinion In The Independent Auditor's Report" deals with the form and content of both types of report. The following are the draft of the opinion paragraphs of the reports.

(*a*) **Adverse Opinion:** We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2023, the consolidated statement of profit and Loss, (consolidated statement of changes in equity) and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements"). In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2023, of its consolidated profit/loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.

(*b*) **Qualified Opinion:** We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 2023, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, Including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)). In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2023 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

17. Discuss the factors affecting the decision of the auditor regarding which type of modified opinion is appropriate.

Ans. The decision regarding which type of modified opinion is appropriate depends upon:

(*a*) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(*b*) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Notes to Add

CONSEQUENCE OF AN INABILITY TO OBTAIN SUFFICIENT APPROPRIATE AUDIT EVIDENCE DUE TO A MANAGEMENT-IMPOSED LIMITATION AFTER THE AUDITOR HAS ACCEPTED THE ENGAGEMENT

After
↓
Request Mgt.→To remove limitation

- **Accepts**
  ↓
  Proceed with Audit Procedures
- **Reject** **→Communicate with TCWG**
  ↓
  Still unable to obtain suff. + Appro. A.E.
  - Qualified **opinion**
    ↓
    EFFECT = Material But Not Pervasive
  - **Withdraw or Disclaimer of Opinion**
    ↓
    Material and Pervasive

Notes to Add

- If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers is likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.
- If management refuses to remove the limitation referred above, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.
- If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:
  - (*a*) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
  - (*b*) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
    - (*i*) Withdraw from the audit, where practicable and possible under applicable law or regulation; or
    - (*ii*) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.
- If the auditor withdraws as contemplated by point (b)(i) above, before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

Test Your Understanding

3. CA. Sarasbhai Patel, while conducting audit of an entity, feels that there is an atmosphere of non-cooperation all around. He has not been provided with necessary support for attending inventory count process of entity as at year end. Besides, CFO is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality.

He was not able to verify revenues of entity due to lack of complete details. For verifying expenses, he has been asking for bills on a sample basis, but staff has been making lame excuses. The matter was brought to knowledge of higher echelons of management, but of no avail. The auditor feels that there could be misstatements and their possible effects would be material and affecting many aspects of financial statements.

Assuming it is not possible to withdraw from engagement, what type of opinion should be expressed by auditor?

Ans. In the given case, auditor has not been able to obtain sufficient appropriate audit evidence relating to inventories, debtors, creditors, revenues and expenses. The matter has brought to knowledge of management but no result has been achieved. Besides, auditor opines that there could be misstatements and their possible effects could be both material and pervasive.

In such circumstances, he should make disclaimer of opinion in accordance with SA 705.

- **The above matter is depicted in the following diagram:**

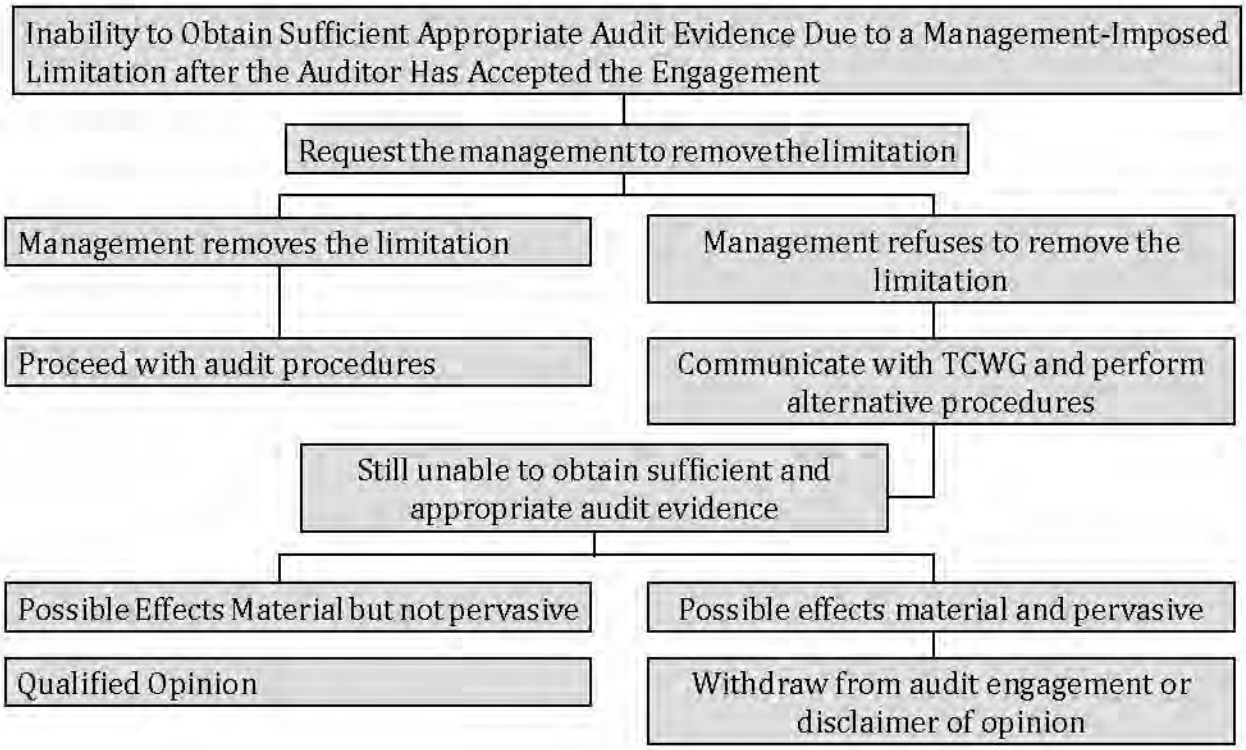


Illustration 12: M/s Daisy & Associates are the statutory auditors of Zebra Ltd. for the FY 2021-22. CA Daisy, the engagement partner wants to verify the cash in hand as on 31.03.2022. The cash balance of the company as on 31.03.2022 is ₹ 1,00,000/- and the turnover of the company for the year is ₹ 6 crores. The management of the company informs CA Daisy that such cash verification is not possible as the cashier is on leave for his marriage and no other employee of the company is available as all are busy in year ending activities. Explain the relevant provisions to deal with such a situation.

Solution: If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers is likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

In the present case CA Daisy, the statutory auditor is unable to verify the cash in hand of Zebra Ltd. as on 31.03.2022. The same is due to a limitation imposed by the management of Zebra Ltd. which is due to the non availability of the cashier. In such situation, CA Daisy should perform alternate procedures to verify the cash on hand of the company. Further, CA Daisy should consider the impact on the auditor's report and may consider issuing a qualified opinion in this case.

Notes to Add

....

....

Notes to Add

FORM AND CONTENT OF THE AUDITOR'S REPORT WHEN THE OPINION IS UNMODIFIED/MODIFIED

OPINION	PHRASES TO USE	NOT TO USE
Unmodified	Present fairly in all material respects	With the foregoing explanation
	Give true & fair view	Subject to
Qualified	**Except for the effects** of matters described in Basis for Qualified opinion ↓ F.S. Present fairly — in acc. with	
Adverse	**Because of** the significance of the matters described in Basis for Adverse opinion ↓ F.S. Do not present fairly — not in acc. with	
Disclaimer	**Do not express an** opinion	
	Not able to obtain suff. + Appro. A.E. ~~FS have been audited~~	

Notes to Add

MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

Auditor's Opinion

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section.

Qualified Opinion

When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section,

(a) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or

(b) When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

Adverse Opinion.

When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section,

(a) When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or

(b) When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

Disclaimer of Opinion

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

(a) State that the auditor does not express an opinion on the accompanying financial statements;

(b) State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(c) Amend the statement required by SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

Notes to Add

BASIS FOR OPINION

→ Amend the heading

↓

Basis for Opinion

- Basis for Qualified Opinion
- Basis for Adverse Opinion
- Basis for Disclaimer Opinion

\+

Include description of matter

↓

Misst.

- Specific Amount
  - Description
  - Quantification
- Not practical to Quantity
  ↓
  State this
- Narrative Disclosure
  ↓
  Explanation

Notes to Add

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

- Amend the heading "Basis for Opinion" required by SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
- Within this section, include a description of the matter giving rise to the modification.

- If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures in the notes to the financial statements), the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable.
- If it is not practicable to quantify the financial effects, the auditor shall so state in this section.
- If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.
- If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:
    (*a*) Discuss the non-disclosure with those charged with governance;
    (*b*) Describe in the Basis for Opinion section the nature of the omitted information; and
    (*c*) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.
- If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.
- When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion required by SA 700 (Revised) to include the word "qualified" or "adverse", as appropriate.
- When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the following elements required by SA 700 (Revised).
    (*a*) A reference to the section of the auditor's report where the auditor's responsibilities are described; and
    (*b*) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.

Notes to Add

DESCRIPTION OF AUDITOR'S RESPONSIBILITIES FOR THE AUDIT OF THE FINANCIAL STATEMENTS WHEN THE AUDITOR DISCLAIMS AN OPINION ON THE FINANCIAL STATEMENTS

↓

Amend the description of Auditor's Responsibilities

↓

Include Statement

- Auditor's Responsibilities
  - To Audit F.S. ↓ acc. to SA
  - To issue an Audit Report
- Auditor ↓ Not able to obtain ↓ Suff. + Appro. A.E.
- Independence + Other ethical Responsibilities

CONSIDERATIONS WHEN THE AUDITOR DISCLAIMS AN OPINION ON THE FINANCIAL STATEMENTS

↓

Not include "key Audit Matters" para

↓

Unless required
- Law
- Regulation

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

↓

When Auditor EXPECTS to MODIFY the opinion

- Circumstances
- Wordings

Notes to Add

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

(a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;

(b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(c) The statement about auditor independence & other ethical responsibilities required by SA 700 (Revised).

Notes to Add

....

....

....

Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.

Notes to Add

....

....

When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification.

Illustration 13: M/s Sun Moon & Associates are the statutory auditors of Venus Ltd. for the FY 2021-22. Owing to the pervasive nature of material misstatements in the financial statements of the company, CA Moon, the engagement partner decided to give an adverse opinion. Explain the responsibility of CA Moon with respect to communication with those charged with governance.

Solution: CA Moon, being the statutory auditor of Venus Ltd. should communicate with those charged with governance about the circumstances that led to the expected modification i.e. an adverse opinion. Further the wording of such modification also needs to be discussed.

Notes to Add

....

....

EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

Emphasis of Matter Paragraph and other Matter Paragraph (SA-706)

↓

Additional Communication to the users of F.S

↓

Necessary as per Auditor's Judgement

↓

To Report a Matter

- Although appropriately presented in F.S.
  ↓
  Important to understand the F.S.
  (Emphasis of Matter Paragraph)
- Any other matter that is relevant to the user's understanding of
  - Audit
  - Auditor's Responsibility
  - Audit Report

  (Other Matter Paragraph)

Notes to Add

SA 706 deals with additional communication in the auditor's report when the auditor considers it necessary to:

(a) Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or

(b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to user's understanding of the audit, the auditor's responsibilities or the auditor's report.

OBJECTIVE OF THE AUDITOR AS PER SA 706

As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgement it is necessary to do so, by way of clear additional communication in the auditor's report, to:

(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

EMPHASIS OF MATTER PARAGRAPHS IN THE AUDITOR'S REPORT

Provided

→ As a result of Matter → Auditor is Not required → to Modify opinion as per SA-705 As per

→ SA-701 → the Matter is Not A Key Audit Matter

DEFINITION OF EMPHASIS OF MATTER PARAGRAPH

- Emphasis of Matter paragraph is a paragraph included in the auditor's report
- that refers to a matter appropriately presented or disclosed in the financial statements
- that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

DEFINITION OF OTHER MATTER PARAGRAPH

- Other Matter paragraph is a paragraph included in the auditor's report
- that refers to a matter other than those presented or disclosed in the financial statements
- that, in the auditor's judgement, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

EMPHASIS OF MATTER PARAGRAPHS IN THE AUDITOR'S REPORT

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

(a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and

(b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

QUESTIONS

Theory Questions

18. Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?

Ans. Emphasis of Matter paragraph: A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(*i*) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(*ii*) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(*iii*) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Notes to Add

Notes to Add

SEPARATE SECTION FOR EMPHASIS OF MATTER PARAGRAPH

Inclusions

(1) Separate Section in Auditor's Report → Heading to Include the term → "Emphasis of Matter"

(2) Paragraph to Include

- Clear reference to matter
- Disclosures in F.S. where matter can be found

(3) Indicate → Auditor's opinion is NOT Modified

Notes to Add

THE INCLUSION OF AN EMPHASIS OF MATTER PARAGRAPH IN THE AUDITOR'S REPORT DOES NOT AFFECT THE AUDITOR'S OPINION

EoM para→ Not a substitute for

- Modified Opinion
- Disclosure in F.S. ↓ App. F.R.F. ↓ Req. Mgt. to achieve ↓ Fair presentation
- Reporting in acc. SA 570 ↓ When material uncertainity exists

Notes to Add

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

An Emphasis of Matter paragraph is not a substitute for:

(a) A modified opinion in accordance with SA 705 (Revised) when required by the circumstances of a specific audit engagement;

(b) Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or

(c) Reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

Notes to Add

Illustration 14: Lomaxe Ltd. is a company engaged in the business of manufacture of candles. CA Kamalnath is the statutory auditor of the company for the FY 2021-22. During the year under audit, there was a fire in the company's factory as a result of which, some of the company's plant and machinery was destroyed. The same was disclosed by the company in the notes to accounts annexed to the financial statements for the year ending 31.03.2022. CA Kamalnath decided to communicate this matter in the auditor's report as he is of the view that the matter is of such importance that it is fundamental to the user's understanding of the financial statements. Help CA Kamalnath to deal with this situation in the auditor's report.

Solution: In the present case there is a need to add Emphasis on Matter Paragraph in the

Auditor's Report. The draft of the same is as under:

Emphasis of Matter – Effects of Fire in Company's Factory

We draw attention to Note Y of the financial statements, which describes the effects of a fire in the Company's factory. Our opinion is not modified in respect of this matter.

Notes to Add

OTHER MATTER PARAGRAPHS IN THE AUDITOR'S REPORT

"Other Matter Paragraph" → Not included in F.S. → Provided

↓

Show in a separate section

↓

(1) Not Prohibited → Law → Regulation

(2) As per SA-701 → The matter is not a Key Audit Matter

Notes to Add

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

↓

When — EoM / OM — Para → expected in Audit Report

Expectation

Wording

COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT (SA 701)

Definition → Matters → were of Most. Significance

↓ In Auditor's Prof. Judgement

↓ In an audit of F.S.

↓ C.Y.

PURPOSE OF COMMUNICATING KEY AUDIT MATTERS

↓

Enhance → Communicative Value of Auditor's Report

↓

By providing → greater transparency

If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgement, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:

(a) This is not prohibited by law or regulation; and

(b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

SEPARATE SECTION FOR OTHER MATTER PARAGRAPH

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.

Notes to Add

SA 701 deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgement as to what to communicate in the auditor's report and the form and content of such communication.

- Key Audit Matters are those matters that, in the auditor's professional judgement
- were of most significance in the audit of the financial statements of the current period.
- Key audit matters are selected from matters communicated with those charged with governance.

PURPOSE OF COMMUNICATING KEY AUDIT MATTERS

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", the purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgement in the audited financial statements.

OBJECTIVES OF THE AUDITOR REGARDING KEY AUDIT MATTERS

- To determine key Audit Matters
- Communicate → Auditor's Report

DETERMINING KEY AUDIT MATTERS

(1) Area of
- **Higher assessed RoMM**
- **Sig. Risk** Identified **→SA 315**

(2) Sig. Auditor's Judgement →Relating to areas in FS.

↓

That invoves

↓

Sig. Mgt. Judgement

(3) Effect on Audit of →Sig.
- **Events**
- **Transactions**

Occured during the pd.

COMMUNICATING KEY AUDIT MATTERS

- Appro. Sub-heading ↓ Each matter
- Separate section
- Introductory Language ↓ State
  - Most Sig. matters ↓ Auditor's prof. Judgement
  - Matters
    - F.S. as a whole
    - In forming Auditor's opinion
    - Does not provide separate opinion

Notes to Add

As per SA 701, "Communicating Key Audit Matters in The Independent Auditor's Report", the objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

Notes to Add

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.

Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.

The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined, as stated above, were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters". The introductory language in this section of the auditor's report shall state that:

(a) Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements [of the current period]; and

(b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

Notes to Add

Notes to Add

COMMUNICATING KEY AUDIT MATTERS-NOT A SUBSTITUTE FOR DISCLOSURE IN THE FINANCIAL STATEMENTS ETC.

Not a substitute for

- Modified Opinion
- Disclosure in F.S. ↓ App. F.R.F. ↓ Req. Mgt. to achieve ↓ Fair presentation
- Reporting in acc. SA 570 ↓ When material uncertainity exists
- Separate opinion on Individual matters

(Modified Opinion, Disclosure in F.S., Reporting in acc. SA 570) — Same as EoM para.

Notes to Add

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

(a) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;

(b) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

(c) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

(d) A separate opinion on individual matters.

QUESTIONS

Theory Questions

19. Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather Communicating key audit matters in the auditor's report is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyse.

Ans. Communicating key audit matters in the auditor's report is not:

(*i*) A substitute for disclosures in the financial statements that the applicable Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;

(*ii*) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

(*iii*) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

(*iv*) A separate opinion on individual matters

Notes to Add

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

- Key Audit matters
- No Key Audit matters
  - As per
    - Facts
    - Circumstances
    - Audit

Notes to Add

The auditor shall communicate with those charged with governance:

(a) Those matters the auditor has determined to be the key audit matters; or

(b) If applicable, depending on the facts and circumstances of the entity and the audit, the auditor's determination that there are no key audit matters to communicate in the auditor's report.

Example: The following illustrates the presentation in the auditor's report if the auditor has determined there are no key audit matters to communicate:

Key Audit Matters

[Except for the matter described in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section,] We have determined that there are no [other] key audit matters to communicate in our report.

SA 701 AT A GLANCE

APPLICABILITY OF SA 701	❑ It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication ❑ This SA applies to audits of complete sets of general purpose financial statements of : ❍ listed entities and ❍ circumstances when the auditor otherwise decides to communicate key audit matters in the auditor's report and ❍ required by law or regulation to communicate key audit matters in the auditor's report However, SA 705 (Revised) prohibits the auditor from communicating key audit matters when the auditor disclaims an opinion on the financial statements, unless such reporting is required by law or regulation. **DETERMINING KEY AUDIT MATTERS:** The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:
	(*a*) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315 (*b*) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty. (*c*) The effect on the audit of significant events or transactions that occurred during the period.

Communicating Key Audit Matters:	The introductory language in this section of the auditor's report shall state that: (*a*) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and. (*b*) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS- A BIRD'S EYE VIEW

The following table gives a summary of the Standards on Auditing related to audit reporting:

Standard on Auditing	Name of SA	Matters dealt with (Scope)
SA 700 (Revised)	Forming an Opinion and Reporting on Financial Statements	❑ The auditor's responsibility to form an opinion on financial statements. ❑ The form and content of the Auditor's Report.
SA 705 (Revised)	Modifications to the Opinion in the Independent Auditor's Report	❑ Auditor's responsibility to issue an appropriate report in circumstances when auditor concludes that a modification to auditor's opinion is necessary. ❑ Three types of modified opinion ❍ A Qualified Opinion ❍ An adverse opinion ❍ A disclaimer of opinion
SA 701	Communicating Key Audit Matters in the Independent Auditor's Report	❑ The auditor's responsibility to communicate key audit matters in the auditor's report. ❑ What to communicate and the form and content of such communication.
SA 706 (Revised)	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	❑ Additional communication in the auditor's report when the auditor considers it necessary to draw users' attention to a matter:
		❍ Presented or disclosed in the financial statements and which is fundamental for the user's understanding. ❍ Not presented or disclosed in the financial statements and which are relevant for the user's understanding.

Notes to Add

THE NATURE OF THE COMPARATIVE INFORMATION

Comparative Information: Corresponding Figures & Comparative F.S. (SA-710)

Nature → Depends upon requirement of → app F.R.F.

Approaches
- Corresponding figure → Auditor's opinion on C.Y. only
- Comparative F.S. → Auditor's opinion of each period

- Law
- Regulation
- Terms of engagement

*Objective
- Comparative info. ↓ Presented ↓ App. F.R.F. } Obtain Suff. + Appro A.E. about this
- Report ↓ As per ↓ Auditor's Reporting Responsibilities

* Definition → Comparative Info.

Amounts / Other Disclosures — Included in F.S. — One / More — Prior pd.

As per app. F.R.F.

Notes to Add

Notes to Add

This Standard on Auditing (SA) deals with the auditor's responsibilities regarding comparative information in an audit of financial statements. When the financial statements of the prior period have been audited by a predecessor auditor or were not audited, the requirements and guidance in SA 510 regarding opening balances also apply.

The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

The essential audit reporting differences between the approaches are:

(*a*) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas

(*b*) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

Notes to Add

Objectives

As per SA 710, the objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and

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

- **The amounts and disclosures included in the financial statements**
- **in respect of one or more prior periods in accordance with the applicable financial reporting framework.**

Notes to Add

AUDIT PROCEDURES REGARDING COMPARATIVE INFORMATION

(1) Determine → F.S. include → Comparative info?

- Required by App. F.R.F.
- Appro Classified?

(2) Evaluate → Comparative info?

- Agrees
  - Amount
  - Other Disclosure
  - Prior pd.
- A/c Policies
  - Consistent
  - Not Consistent ↓ Δ ↓ Properly
    - Accounted
    - Presented
    - Disclosed

(3) Possible Misst.?

- No
- Yes → perform Additional Audit Procedures + Requirement of SA 560 ↓ Only if Auditor had Audit prior pd. F.S.

(4) Obtain W.R.

Notes to Add

- The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:
  (*a*) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
  (*b*) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.
- If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560.
- As required by SA 580, the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

Notes to Add

AUDIT REPORTING REGARDING CORRESPONDING FIGURES

Definition → Comparative info → Where → Amount / Other Disclosure

↓

of prior pd.

- Included as Integral part of C.Y.F.S.
- Intended to be read ↓ Only in relation to ↓ C.Y.

→ Auditor's opinion shall Not Refer → to corresponding figures

Except

- Auditor's Report on prior pd. ↓ Included a modified opinion + Matters which give rise to modification is unresolved ↓ **Auditor shall modify** ↓ **C.Y.F.S. opinion**
  - **In Basis for Modification para**
    - **If matter** ↓ **Material** ↓ **Refer Both**
      - **C.Y. fig.**
      - **Corresponding fig.**
    - **Other cases** ↓ **Explain → Modified opinion** ↓ **Because of unresolved matters**
- Auditor obtains A.E. ↓ M. M. Exists ↓ In prior Pd. Statements ↓ On which unmodified opinion is previously issued ↓ Dealt with as per app. F.R.F. ↓ If NOT ↓ **Auditor shall express**
  - **Qualified** / **Adverse** — **Opinion** ↓ **On C.Y.F.S.**
- Prior Period F.S. ↓ NOT Audited ↓ State in "Other Matter Paragraph (SA-706)" ↓ That corresponding fig. are unaudited ↓ But Auditor has to follow SA 510

Notes to Add

*Prior period Financial Statements Audited by a Predecessor Auditor

+

Auditor → permitted by — [Law / Regulation] — Refer to → Predecessor Auditor's Report

↓

State in OM para

- F.S. → prior pd. ↓ Audited by predecessor Auditor
- Type of opinion ↓ Predecessor Auditor ↑ Reason ↑ If Modified opinion
- Date of previous Report

Definition of Corresponding figures:

Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements → and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures"). → The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Notes to Add

....

....

....

....

....

....

....

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

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

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

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

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

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

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

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

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

Prior Period Financial Statements Audited by a Predecessor Auditor

If the financial statements of the prior period were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report:

(a) That the financial statements of the prior period were audited by the predecessor auditor;

(b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and

(c) The date of that report.

COMPARATIVE FINANCIAL STATEMENTS

→ Auditor's opinion refer to Each Period

→ Reporting on prior period F.S. → in connection with → with → current period audit

↓

Auditor's opinion → Differs → from opinion expressed previously

↓

Disclose

↓

Substantive reason → for different opinion

↓

In other Matter paragraph (SA-706)

*Prior Period Financial Statements Audited by a Predecessor Auditor

Auditor shall

- Express Opinion on C.Y.F.S.
- State in OM para
  - F.S. → prior pd. ↓ Audited by predecessor Auditor
  - Type of opinion ↓ Predecessor Auditor ↑ Reason ↑ If modified opinion
  - Date of previous Report

Unless predecessor Auditor's Report → Revised

***If Auditor concludes → MM exists → that affects**

↓ **Communicate**: **Mgt.** | **TCWG** | **Request predecessor Auditor to be informed**

↓ **prior pd. F.S.** ↓ **Predecessor Auditor gave** unmodified **opinion**

***if priod pd. F.S.** ↓ **Amended** + **Predecessor Auditor** ↓ **Agrees to issue New Report**

Auditor shall report only C.Y.

Definition: Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor 's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Auditor's opinion-to refer each period: When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed.

When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706.

Prior Period Financial Statements Audited by a Predecessor Auditor

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

(a) That the financial statements of the prior period were audited by a predecessor auditor;

(b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and

(c) The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and those charged with governance and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period.

Prior Period Financial Statements Not Audited

If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Notes to Add

AUDIT OF BRANCH OFFICE ACCOUNTS [SEC.128(1)

Co. → Prepare & Keep → on
- Accrual Basis
- Double Entry System

Books of A/c.'s | Relevant Books | Papers & F.S

Which gives true & Fair view of
- Co.
- Branch + Explains Transactions between H.O. & Branch
- Double Entry System

↓

For every year

↓

at

R.O. | Any other place | Electronic mode

Any other place: Decided by BOD → Notice to ROC → within 7 days

- If Branch → outside India & In India → Sec.128(1) will be satisfied → if → Proper periodic Return

R.O. | Any other place prescribed

Sec.143(8) Continue from Duties of Auditor

Audit of Branch

H.O. Auditor | Any other (Branch Auditor)

Accountant + According to laws of that country

- If Branch is outside India
- Branch Auditor → Sends Report → H.O. Auditor
- Reporting of Fraud as → Applies to Branch Auditor → Limited to Branch only per Rule 12, CAAR, 2014.

Notes to Add

Audit of Branch Office Accounts

→ Definitions

Principal Auditor
↓
Auditor with Responsibility of Reporting
↓
On entity Fin. Info.
↓
Includes
↓
Fin. Info.

One | More
Components
↓
Audited by another Auditor

Other Auditor
↓
Other than principal Auditor
↓
With responsibility of reporting
↓
On fin. Info.
↓
Of a component
↑
Which is included
↑
Fin info. Audited by principal auditor

Component

- ❑ Division
- ❑ Branch
- ❑ Subsidiary
- ❑ JV
- ❑ Associated enterprise
- ❑ Other entity

↓
Whose fin. Info.
↓
Included in fin. Info. Audited by principal Auditor

Notes to Add

As per section 128(1) of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

It may be noted that all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within 7 days thereof, file with the Registrar a notice in writing giving the full address of that other place.

Students may also note that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

Sub-section (2) provides that where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of sub- section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place referred in (1).

Further, sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this

Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company' s auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

For better understanding, let us now have a look at the following definitions:

- **Principal auditor** means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.
- **Other auditor** means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor.
- **Component** means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

USING THE WORK OF ANOTHER AUDITOR (SA-600)

Generally the Principal Auditor → relies over → work of → Component Auditor

Unless

For special circumstances → that neccissiates → Principal Auditor → to

Perform Procedures to obtain

Sufficient & Appropriate Audit Evidance (AE)

+

Advice the Branch Auditor about

- **Use of his work**
- **Arrangement of coordination of their effort**
- **Areas for special consideration**
- **Time Table**
- Significant
  - **Accounting**
  - **Auditing**
  - **Reporting**

Requirment

+

Obtain W.R. as to compliance

The principal Auditor → Might → via
- Questionnaire
- Check-list

- Discuss → Audit Procedures applied
- Review → Written summary
- Visit

Notes to Add

Using the Work of another Auditor: When the accounts of the branch are audited by a person other than the company's auditor (or principal auditor), there is need for a clear understanding of the role of such other auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in SA 600, "Using the Work of another Auditor". It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.

Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

(a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter -component transactions that may require disclosure and the time-table for completion of audit; and

(b) Advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

Test Your Understanding

4. CA. Dicky Yadav is auditor of a company having four branches. The four branches are audited by another auditor CA. Yamini Jain. The reports in respect of accounts of branches examined by her have already been sent to company auditor. During the course of audit, CA Dicky Yadav asks the branch auditor to share with her summary of audit procedures and findings in respect of accounts of branches examined. CA. Yamini Jain feels it as encroachment of her domain. Discuss the issue.

Ans. As per SA 600 - "Using the Work of Another Auditor", the principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. Such review of audit procedures and findings can be undertaken if principal auditor feels that it is necessary to apply such procedures to obtain sufficient appropriate audit evidence. It is not an encroachment of another auditor's domain.

JOINT AUDIT

↓

pooling together — Resources / Expertise — One firm of Auditors

* Involves → sharing → Total work

* Advantages / Disadvantages

Advantages	Disadvantages
(1) Sharing → expertise	(1) Fees → shared
(2) Mutual consultation	(2) Psychological Problems
(3) Lower workload	(3) Superiority Complex
(4) Better Quality	(4) Co-ordination Problem
(5) Lower cost	(5) Uncertainity → Liability

SA 299 (Revised) – Joint Audit of F.S
+
SA 200 – "Overall Objectives of an Independent Auditor & Conduct of an Audit in Accordance with SA"
— **Lays down special consideration for JA**

(*i*) **Engagement Partner**
+
Other key member of Engagement Team — **From each JA → should be involved in planning the audit**

(*ii*) **JA should → Jointly establish → Overall Audit strategy → which sets overall**

Scope | **Timing (T)** | **Direction**
of Audit +
Guides development of Audit plan

(*iii*) Before commencement of Audit
→ J.A. Should → Discuss → Develop → J.A. Plan → Regarding

- Identify Division of Audit areas + Common Audit areas
- Ascertain ↓ Reporting objectives of the engagement
- Consider + Communicate amongst all J.A ↓ The factor that are significant
- Consider result of preliminary engagement activities
- Ascertain
  - Nature (N) | Timing (T) | Extent (E)
  - of
  - Measures necessary

(iv) Each J.A. → Consider → Assess → RoMM (Risk of Material Misstatement)

+

Communicate to other J.A

(*v*) J.A. Should → Discuss → Document → N.T.E. of Audit Producers → for → Common → Specific → Areas allotted (*vi*) J.A. should obtain → Common Engagement letter → Common Mgt. Representation Letter.

(*vii*) The work allocation letter should be → Signed by All J.A. → Communicate to TCWG (Those charged with Governance.

- Each Auditor is responsible → Only for work allotted → to him
- Jointly & severally liable :-
  - (1) Work not divided + carried on by all
  - (2) Decisions taken by all
  - (3) Matters on which arrangement is there
  - (4) Disclosers relating to
    - (i) Statues, (ii) F.S., (iii) Audit Report)

❑ The JA should Communicate to other JA

↓

In writing + Prior to completion of Audit

- Matters relavent to areas of responsibiblity of other JA
- Deserves their attention
- Require Desclosure
- Require Discussion
- Application of Judgement

→ J.A are required to issue → common Audit Report

→ If in Disagreement → Separate Audit Report + But shall make reference in each others Audit Report

Notes to Add

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the advantages that flow may be the following:

(*i*) Sharing of expertise.

(*ii*) Advantage of mutual consultation.

(*iii*) Lower workload.

(*iv*) Better quality of performance.

(*v*) Improved service to the client.

(*vi*) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.

(*vii*) Lower staff development costs.

(*viii*) Lower costs to carry out the work.

(*ix*) A sense of healthy competition towards a better performance.

The general disadvantages may be the following:

(*i*) The fees being shared.

(*ii*) Psychological problem where firms of different standing are associated in the joint audit.

(*iii*) General superiority complex of some auditors. Problems of co-ordination of the work.

(*iv*) Areas of work of common concern being neglected.

(*v*) Uncertainty about the liability for the work done.

The Institute of Chartered Accountants of India has issued Standard on Auditing (SA) 299 (Revised), "Joint Audit of Financial Statements" which lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing". This Standard deals with the special considerations in carrying out audit by joint auditors. It requires that–

(*i*) the engagement partner and other key members of the engagement team from each of the joint auditors should be involved in planning the audit.

(*ii*) the joint auditors should jointly establish an overall audit strategy which sets the scope, timing and direction of the audit, and also guides the development of the audit plan.

(*iii*) before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:

  (*a*) identify division of audit areas and common audit areas;

  (*b*) ascertain the reporting objectives of the engagement;

  (*c*) consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;

  (*d*) consider the results of preliminary engagement activities, or similar engagements performed earlier.

  (*e*) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

(iv) each of the joint auditors should consider and assess the risks of material misstatement and communicate to other joint auditors.

(v) the joint auditors should discuss and document the nature, timing, and the extent of the audit procedures for (I) common and (II) specific allotted areas of audit to be performed.

the joint auditors should obtain common engagement letter and common management representation letter.

(vi) the work allocation document should be signed by all the joint auditors and communicated to those charged with governance.

It further states that, in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. On the other hand, all the joint auditors shall be jointly and severally responsible for:

(i) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;

(ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas;

(iii) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;

(iv) examining that the financial statements of the entity comply with the requirements of the relevant statutes;

(v) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;

(vi) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

In case a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

It may be noted that the joint auditors are required to issue common audit report. However, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s).

[Note: Student may refer SA 299 (revised) "Joint Audit of Financial Statements" reproduced in "Auditing Pronouncements" for comprehensive knowledge.]

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

20. The concept of "joint audit" has legal foothold under the Companies Act, 2013.

Ans. Correct: Under provisions of section 139(3), the members of a company may resolve to provide that audit shall be conducted by more than one auditor. Hence, the concept of "joint audit" has legal foothold also under Companies Act, 2013.

21. In Joint Audit, "Each Joint Auditor is responsible only for the work allocated to him".

Ans. In respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. On the other hand, all the joint auditors shall be jointly and severally responsible for:

(*i*) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;

(*ii*) decisions taken by all the joint auditors under audit planning in respect of common audit areas;

(*iii*) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;

(*iv*) examining that the financial statements of the entity comply with the requirements of the relevant statutes;

(*v*) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;

(*vi*) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

22. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.

Ans. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:

(*a*) identify division of audit areas and common audit areas;

(*b*) ascertain the reporting objectives of the engagement;

(*c*) consider and communicate among all joint auditors the factors that are significant

(*d*) in directing the engagement team's efforts;

(*e*) consider the results of preliminary engagement activities, or similar engagements performed earlier.

(*f*) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

23. The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit.

Ans. Joint Audit: The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the advantages that flow may be the following:

(*i*) Sharing of expertise.

(*ii*) Advantage of mutual consultation.

(*iii*) Lower workload.

(*iv*) Better quality of performance.

(*v*) Improved service to the client.

(*vi*) Displacement of the auditor of the company taken over in a takeover often obviated.

(*vii*) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.

(*viii*) Lower staff development costs.

(*ix*) Lower costs to carry out the work.

(*x*) A sense of healthy competition towards a better performance

24. HMB Limited's business has grown from one state of India to various countries of the world. Since the business has increased manifold, the management decided to appoint joint auditors for conducting the statutory audit of the company. They appointed three CA firms for it. For which audit work the joint auditors will be jointly & severally responsible?

Ans. Joint Audit of Financial Statements:

As per SA 299, "Joint Audit of Financial Statements", all the joint auditors shall be jointly and severally responsible for:

(*i*) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;

(*ii*) decisions taken by all the joint auditors under audit planning in respect of common audit areas;

(*iii*) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;

(*iv*) examining that the financial statements of the entity comply with the requirements of the relevant statutes;

(*v*) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;

(*vi*) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

Notes to Add

REPORTING REQUIREMENTS UNDER THE COMPANIES ACT, 2013

Duties of Auditor

(i) Duty to Inquire on certain matters ← Report only if the matter is in ADVERSE [Sec 143(1)]

- Loans & Advances
  - Given by the Co.
    - On the basis of security
      - Properly Secured — T & C are not prejudicial to the interest of
        - Co.
        - Members
- Transactions
  - Merely book entries
    - Not prejudicial to the interest of Co.
- Whether
  - Assets of the Co.
    - Sold < Cost Exceptions
      - Exception: Investment Co. & Banking Co.
- Whether
  - Loans & Advances
    - Shown as Deposits
- Whether
  - Personal Expenses
    - Charged to Revenue A/c
- Whether
  - Shares allotted for cash
    - Cash Received
      - Yes
      - No
        - Properly disclosed in A/c. & B/s

(ii) Reporting → on

- A/cs examined [Sec 143 (2)]
- Every — F.S. / Report — Laid in GM
- To the best of — Knowledge / Belief
  - ↓ F.S. gives — True / Fair — view
    - Company's Affair's
    - P/L A/c
    - CFS
    - Other matter (Rule 11)

To members

Taking A/c of

- Provisions of the companies At, 2013
- AS + SA
- Rules

(*iii*) Duty to report (Sec. 143(3)

(*a*) Saught + Obtained → Info + Explanation → Best of knowledge + Belief

Yes

No → Details there of + Effect on FS

(*b*) As per his opinion
- Proper books are maintained as per law
- Proper returns from branches not visited by him

(*c*) Report as Sec. 143(8)
- Sent to him → by branch Auditor
- Manner in which he has dealt with it

Even books of branches are within rights

(*d*) B/S + P/L → in agreement → Books of A/c. + Returns

(*e*) F.S. → Comply → AS

(*f*) Adverse → Observation + Comment → on financial matter/ transaction

(*g*) Directors → Disqualified → u/s. 164(2)

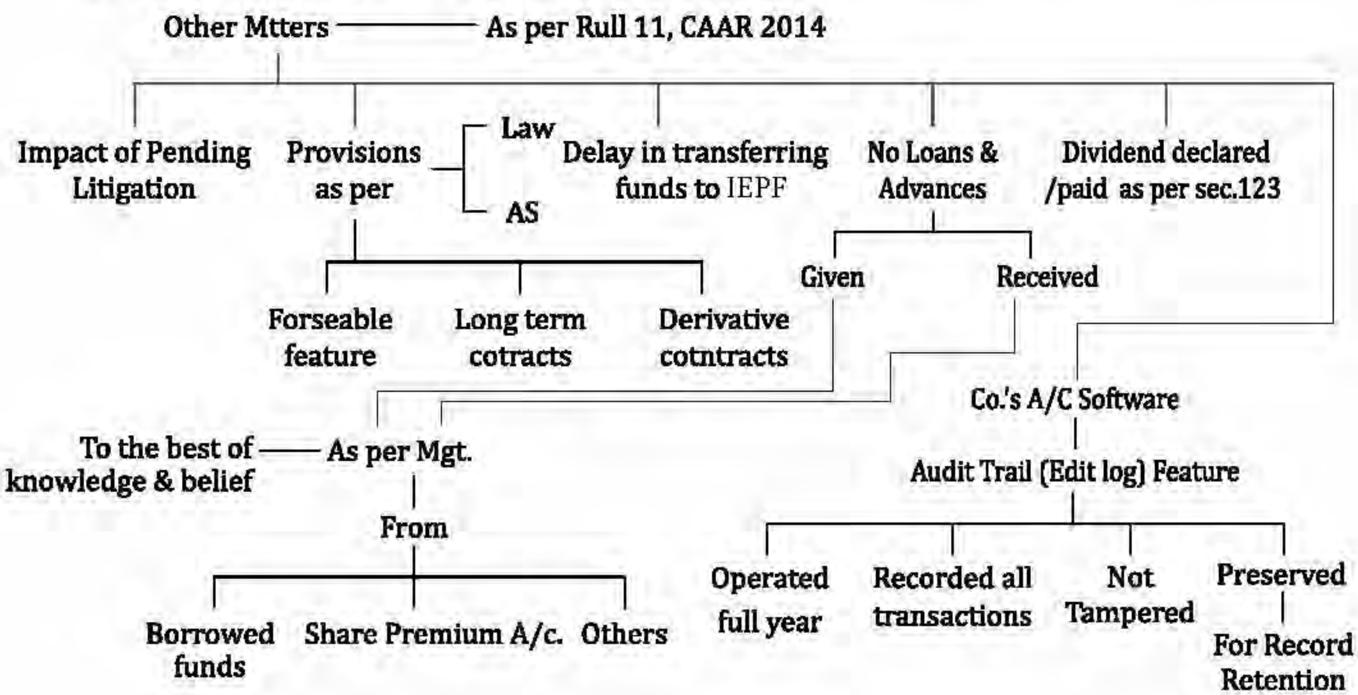
(*h*) Qualification + Reservation + Adverse Remarks → Maintenance of A/c. + Other Matters

(*i*) Adequate + Effective → Internal Financial Control → w.r.t. + FS

Exception:

Pvt. Co. → OPC → Small Co. → Co. → T/o. < ₹50 Crore → Borrowings < ₹25 Crore

(*j*) Other Matters → As per rule 11, CAAR, 2014



To

Any other Person | **Foreign Entity**

With understanding

Directly — **Lend/Invest** — **Indirectly**

Ultimate Beneficiaries

(iii) Duty to report on any other matter specied by CG

Eg : CARO, 2020

CG → Consult → NFRA

Pass — For such — Class / Description — Of Co's

General / Specific

Order

That → Auditor should include a statement

(v) Duty to Report Fraud → If Auditor → In course of performance → CA

→ Cost Auditor (Sec.148)

Has reason to believe → Company Secretary (Sec.204)

Fraud Occured

≥ ₹1 Crore

Report to CG
(Sec. 143(12) + Rule 13, CAAR, 2014)

< ₹1 Crore

Report to

Audit committee or Board of Directors
+
Clause (xi) of para 3 of CARO, 2020

Disclosure in Board Report

Reporting Requirements Under The Companies Act, 2013

Section 143 of Companies Act, 2013 contains, inter alia, reporting requirements of auditor of a company in form of duties.

(1) Reporting requirement relating to matters stated in section 143(1)

Under section 143(1), auditor shall inquire into following matters given as under: -

(*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 deposits;

(*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.

However, 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. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. 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.

(2) Reporting on accounts examined

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 sub- section (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.

Further, in terms of section 143(3), the auditor's report shall also state

(*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, the 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 under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section 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 the 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 controls with reference to financial statements in place and the operating effectiveness of such controls;

However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a–

(*i*) One person company; or

(*ii*) Small company; or

(*iii*) Company having turnover less than ₹50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than ₹25 crore.

(*j*) such other matters as are prescribed in Rule 11 of the Companies (Audit and Auditors) Rules, 2014 which are as under:-

(*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 amounts, 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 (1) and (2) contain any material misstatement.

(*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 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.

While reporting, 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 therefor in terms of Section 143(4). Further, every auditor shall comply with the auditing standards as required under section 143(9).

(3) Reporting on any other matter specified by Central Government: 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.

[Note: Students may note that Companies (Auditor's Report) Order, 2020 has been notified in this perspective which is discussed later in this chapter as Reporting under Companies (Auditor's Report) Order, 2020]

(4) Reporting on frauds:

(*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 ₹ 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.

Besides, auditor has also to report matters pertaining to fraud at point (*xi*) of paragraph 3 of CARO,2020 which is discussed subsequently.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

25. The auditor has to report under section 143 of companies act, 2013 whether company has adequate internal controls in place and overall effectiveness of such internal controls.

Ans. Incorrect: Under provisions of Section 143 of the companies Act, 2013, auditor has to report whether the company has adequate internal financial controls with reference to financial statements in place and operating effectiveness of such controls. The auditor has to report on adequacy and effectiveness of internal financial controls only and not internal controls.

26. If an LLP (Limited Liability Partnership Firm) is appointed as an auditor of company, every partner of a firm shall be authorized to act as an auditor.

OR

Any partner of an LLP, who is appointed as an auditor of a company, can sign the audit report.

Ans. Incorrect: As per section 141(2) of the Companies Act, 2013, where a firm including a limited liability partnership (LLP) is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorized to act and sign on behalf of the firm.

27. Discovery of an offence of a fraud of ₹100 lakh by auditor against the company committed by its officers is to be reported to Serious Fraud Investigation office(SFIO).

Ans. Incorrect: Fraud of ₹100.00 lakhs or above (i.e. ₹1.00 crore or above) has to be reported to Central government (precisely to Secretary, Ministry of Corporate affairs) in Form ADT-4.

28. Auditor has to disclose the impact, if any, of the pending litigations on the financial position of the auditee in his audit report.

Ans. Incorrect: Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on - whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement.

Theory Questions

29. According to Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report in accordance with the relevant provisions of the Act. Explain clearly the relevant provisions relating to signing of report.

Ans. Duty to Sign the Audit Report: As per section 145 of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of section 141(2).

Section 141(2) of the Companies Act, 2013 states that where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorized to act and sign on behalf of the firm. The qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting.

30. As per Sec 143(3)(j) of the Companies Act, 2013, the auditor's report shall also include such other matters as may be prescribed by Rule 11 of the Companies (Audit and Auditors) Rule, 2014. Discuss those matters on which views and comments of the auditor are required.

Ans. Others Matters prescribed by Rule 11 to include in Auditor's Report:

As per section 143(3)(j)- the auditor's report shall also state such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-

(*i*) Whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(*ii*) 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;

(*iii*) Whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

(*iv*)

(1) 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;

(2) 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, 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

(3) 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.

(*v*) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

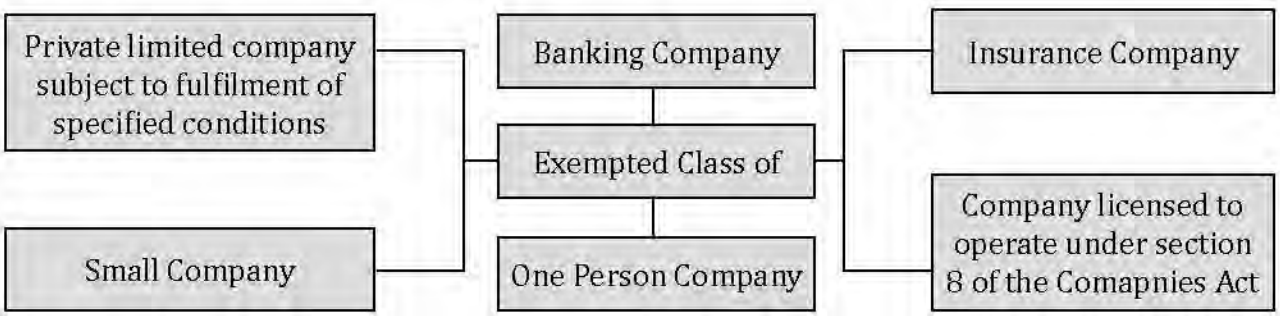
Notes to Add

■ REPORTING UNDER COMPANIES AUDITOR'S REPORT ORDER, 2020 [CARO, 2020]

- Additional Reporting Requirement → Shall not apply to CFS → Except Point
- Applicable to every co. [including Foreign Co.→ Sec. 2(42)]

Except:

(*i*) Banking Co. → Registered u/s 5(*c*) of The Banking Regulation Act, 1949
(*ii*) Insurance Co. → Registered under The Insurance Act, 1938
(*iii*) Sec.8 Co.
(*iv*) OPC
(*v*) Small Co.
(*vi*) Private Co. —
- Not a Holding / Subsidiary Co. of a Public Co.
- Paid up share Capital + Reserve & Surplus ≤ ₹1 Crore
- Borrowings → Banks → F.I. ≤ ₹1 Crore → at any time
- Revenue ≤ ₹10 Crore



Notes to Add

In exercise of the powers conferred by sub-section (11) of section 143 of the Companies Act, 2013 (18 of 2013) and in supersession of the Companies (Auditor's Report) Order, 2016, published in the Gazette of India, Extraordinary, Part II, Section 3, Sub-section (ii), vide number S.O. 1228 (E), dated the 29th March, 2016, except as respects things done or omitted to be done before such supersession, 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

Notes to Add

....

....

Short title, application and commencement.

Short title: This Order may be called the Companies (Auditor's Report) Order, 2020.

Application: It shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013 (18 of 2013) [hereinafter referred to as the Companies Act], except–

(*i*) a banking company as defined in clause (*c*) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);

(*ii*) an insurance company as defined under the Insurance Act,1938 (4 of 1938);

(*iii*) a company licensed to operate under section 8 of the Companies Act;

(*iv*) 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

(*v*) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and 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 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.

Commencement: It shall come into force on the date of its publication in the Official Gazette.

Example: 'Educating Child' is a limited company registered under section 8 of the Companies Act, 2013.

In the given case, 'Educating Child' is licensed to operate under section 8 of the Companies Act, 2013. Therefore, CARO, 2020 shall not be applicable to 'Educating Child' accordingly.

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.

Notes to Add

....

■ MATTER TO BE INCLUDED (PARAGRAPH 3 & 4)

(*i*) Property, Plant & Equipment (PPE)

(*a*) Co. → Maintaining → Proper Records → of PPE
- Quantitative Details
- Situations

of I.A.

Physical Verification (*b*)
- **By Management**
- **At reasonable Intervals**
- **If any discrepancy found**
- **If yes, properly dealt with?**

(*c*) Immovable properties → Title Deeds → In the Name of Co.

Other Than → Properties Co. is Lessee + Lease Agreement → In favour of Lessee

- Yes
- Other → Details there of
  - Description
  - Gross carrying value
  - Held in name of
  - Promoter / Director / Relative / Employee
  - Period held
  - Reason

(*d*) Co. → Revalued
- PPE
- Intangible Assets
- Right of use of Asset

- Yes
  - Based on Valuations by Registered Valuers?
  - Specify → Amount of change → of ≥ 10% of net carrying value of each class of PPE + I.A.
- No

(*e*) Proceeding against the Co. → for holding' Benami Property'
- Initiated
- Pending

Benami Transaction (Prohibition) Act, 1988

- Yes ↓ Details disclosed in F.S?
- No

(*ii*) <u>Inventories:</u>

(*a*) Inventories → Physical Verilcation
↓
By Management
↓
at Reasonable Interval
↓
If any material discrepancy → ≥ 10% of each class of Inventor

- Yes
  - Properly dealt with in books of A/c
- No

(*b*) Working Capital limit → Bank → F.I
↓
Sanctioned → > ₹5 Crore
↓
On the basis of security of C.A.

- **No**
- **Yes**
  - **Quarterly Returns** **OR** **Statement**
    - **In Agreement → Books of A/c.'s**
      - **Yes**
      - **No → Details**

(*iii*) Co.

- to
  - Co.
  - Firm
  - LLP
  - Other Party
- Made Investment
- Provided
  - Guarantee
  - Security
- Granted
  - Loans
  - Advances
    ↓
    In nature of loans

- No
- (a) Yes
  ↓
  Indicates

Aggregate amount during the year | Balance O/s at B/s date

- (A) Subsidiary, J.V., Associates
- (B) Others

(*b*) T& C → are not projedicial to the interest of the co.

(*c*) Schedule of Repayment of Principal / Payment of Interest — Stipulated ? + Regular?
- Repayment
- Receipts

(*d*) Overdue → State
- Total amount overdue > 90 days
- Reasonable steps taken by the co → for recovery
  - Principal
  - Interest

(*e*) Loans & Advances → Specify
- Renewed
- Extend
- Fresh loans granted to settle the overdues

— Agrgegate amount renewed

— % age of aggregate to total loans & Advances

(*f*) Co. granted → Loans & advances
- Aggregate amount
- % age of total loans granted
- Loans to
  - Promoters
  - Related parties

— Repayable on demand

— Without specifying
- Terms
- Period

Of repayment

(*iv*) Loans & Advances : In Respect of
- Loans
- Investment
- Guarantee
- Security

Check Applicability
- Sec.185 — Prohibition on granting loans
- Sec.186 — Limits on Granting Loans

(*v*) Accepts Deposits : Directive / Orders
- RBI
- CLB
- NCLT
- Any other court/tribunal

Complied with
- Yes
- No —— Nature of contravertion to be stated

(*vi*) Cost audit : Sec 148(1) → Complied with
- Yes
- No

Cost Records

(*vii*) Statutory Dues
- PF, ESI, Income Tax, GST, VAT, Custom Duty, Cess, etc.
- Undisputed
  - Regular
    - Yes
    - No
      - Extent of arrears o/s
        - As on the last day of F.Y
          - > 6 months dues only
- disputed
  - Amount of Dispute
  - Forum where dispute is pending
    - A mere representation to concerned dept. # Dispute

(*viii*) Any transaction → not recorded → Books of A/c.

Surrendered / Disclosed → As Income → In Income Tax Assessment

Previously unrecorded Income → Properly Recorded → in Books of A/c.

(*ix*) Repayment of
- Loans
- Borrowings
- Interest

Default
- Yes
  - Nature Of Borrowing
  - Principal or interest
  - Remark
  - Amount of Default
  - Period of Default +
- No

Lender wise detail → In case of default to
- Banks
- F.I.
- Government

(*a*) Co. → Declared → Wilful defaulter → by
- **Bank**
- **F.I.**
- **Other lender**

(*b*) Term Loan → Applied → For the purpose for which loans were obtained
- **Yes**
- **No**
  - **Report**
    - **Amount of loan so diverted**
    - **Purpose for which it is used**

(*c*) Short term funds → used for → Long Term Purpose
- **No**
- **Yes**
  - **Nature**
  - **Amount**

(*d*) Co. → Taken funds → from any
- Entity
- Person

To meet obligation of
- Subsidiary
- Associate
- J.V

- No
- Yes — Details
  - Nature
  - Amount

(*e*) Co. → Raised loan → Pledge of Security → held in
- Subsidary
- Associate
- J.V.

- No
- Yes
  - Report
    - If Co. has defaulted in repayment of such loan

(*x*) IPO / FPO / Term Loan: → Applied for specified purpose

(*a*)
- **No**
- **Yes — Details**
  - **Defaults**
  - **Delays**
  - **Subsequent** Rectifications

(*b*) Pref. Allotment
Pvt. Placement
Convertible
Deebentures
— **Sec 42 & 62 → complied?**
+
Funds applied for same purpose
- **Yes**
- **No**
  - **Nature**
  - **Amount**

(*xi*) Fraud : (*a*) on the Co. / By the Co.
- Officer / Employee
  - No
  - Yes → Nature + Amount

+

(*b*) ADT – 4 → filed ?

(*c*) Wistle – blower → Complaints → Considered ?

(*xii*) Nidhi Co. → Complied with → Nidhi Rules, 2014
- NBFC

- $\frac{\textbf{Net Owned Funds}}{\textbf{Deposit}} = \frac{1}{20}$
- 10% Unencumbered Term Deposit

Any default in payment of
- Interest
- Repayment

(*xiii*) Related Party Transactions :

As per Sec. 177 → Audit Committee

As per Sec. 188 → Restriction on Related Party Transaction

→ Disclosed in F.S → as per AS - 18

(*xiv*) (*a*) Internal Audit System → Commersurate → with Nature / Size of business

+

(*b*) Report of Internal Auditor — Considered by — Statutory Auditor

(*xv*) Non Cash Transactions — Director / Connected persons

If so? → Sec 192 Complied with?

Directors / Connected Persons Cannot acquire shares of Co.

- Without approval
- For consideration other than cash

(*xvi*) NBFC → Co. required to be

(*a*) Registered → u/s 45 IA of the RBI Act, 1934

↓

To be regarded as NBFC

(*b*) Valid Registration obtained?

(*c*) → Co. → Core Investment Co. (CIC) + Criteria still fulfilled?

+

(*d*) Indicate No. of CIC in group

(*xvii*) Co. → incurred Cash Loss → Current F.Y. → Previous F.Y.

↓

State the amount

(*xviii*) Resignation of statutory Auditor? → Yes → Incoming Auditor → Considered?

Issues — Objections — Concerns

of outgoing auditor

(*xix*) On the basis of → Auditor is of opinion → Material uncertainity exists

Co. is capable of meeting its liabilities existing on B/S date

When they fall due within a period of 1 year from B/S date

Financial Ratios

Ageing + Expected date of Realisation of financial Assets

Payment of financial Liabilities

Other info accompaning F.S.

Auditor's Knowledge of

BOD

Management

Plan

(*xx*) Co.→ transferred → unspent amount to

(a)
Schedule VII Fund
↓
As per Sec.135 (5)
↓
Within 6 months of Expiry of F.Y
↓
Other than ongoing projects

(b)
Special A/c.

As per Sec. 135 (6)

On going projects

(*xxi*) Auditor Made → Qualification/Adverse Remark → in CARO Report → in CFS

No

Yes
↓
Indicate
↓
Details of Co.
↓
Paragraph No.
of CARO Report

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*) (*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;

(*f*) 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;

(*g*) 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*)

(*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 anyt 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*)

(*a*) whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, 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*)

(*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	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*) (*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 noncompliance;

(*xi*) (*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*) (*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 per cent. 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*) (*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*)

(*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 subsection (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.

Paragraph 4. 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 opinion 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 on the same.

Notes to Add

....

....

....

....

....

....

Notes to Add

Paragraph 4 of CARO 2020

Reason + Basis to be stated for

Unfavourable | **Qualified** | **Not able to express an opinion on any of the above matters + Reason**

Answer

Notes to Add

Test Your Understanding

5. CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to ₹4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, ₹1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements.

Is there any reporting obligation upon him under CARO,2020?

Ans. Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

In the given situation, funds have been raised for meeting working capital requirements for ₹4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, ₹1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose.

Hence, the matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

Example: The company has dispensed with the practice of taking inventory of their inventories at the year-end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations. Explain reporting requirement under CARO, 2020.

Reporting for Physical Verification of Inventory:

Clause (ii) of Para 3 of CARO, 2020, requires the auditor to report

(*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;

In the given case, the above requirement of physical verification of inventory by the management has not been taken place and therefore the auditor should point out the same under CARO, 2020. He may consider the impact on financial statement and report accordingly.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

31. According to CARO 2020, the company auditor is required to state that whether the title deeds of all immovable properties held in the name of the company are disclosed in its financial statements.

(PYQ May 2022)

Ans. Incorrect: According to CARO, 2020, the company auditor is required to state 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.

32. Mr. T, the director of A Ltd., has purchased an old car belonging to the company against the cooling equipment belonging to the director, which is given to the company as consideration for the car. The auditor is not required to include this in his CARO report. **(PYQ Nov 2022)**

Ans. Incorrect: The auditor is required to report the same as per clause (xv) of Paragraph 3 of directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with". CARO, 2020, "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.

Theory Questions

33. Explain the Reporting requirements the auditor should ensure under CARO 2020 related to PPE and Intangible assets.

Ans. Reporting for PPE and Intangible assets - Clause (i) of Para 3 of CARO, 2020, requires the auditor to include a statement in the auditor's report on the following matters, namely –

(*i*) (*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.

34. G Pvt. Ltd. had fully paid up Capital and Reserves of ₹1.20 crore as at the end of F.Y. 2020-2021. During the F.Y 2021-2022, business was interrupted due to Covid restrictions and therefore the company incurred losses to the tune of ₹25 lacs. During the year, the company also borrowed ₹55 lakh each from a bank and a financial institution independently. It had a turnover of ₹850 lakh (other than revenue of ₹250 lakh from discontinuing operations). Ascertain whether CARO, 2020 is applicable to the company.

Ans. Applicability of CARO, 2020 in case of Private Ltd. Company: CARO, 2020 shall apply to every company including a foreign company except– a private limited company, not being a subsidiary or holding company of a public company,

(*i*) having a paid-up capital and reserves and surplus not more than one crore rupees as on the balance sheet date; and

(*ii*) 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

(*iii*) 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 Applying the above to the given case, G Pvt. Ltd., its paid-up capital and reserves are ₹95 Lakh (₹120 Lakh - ₹25 Lakh), borrowings from a Bank and financial institution are (₹55 Lakh + ₹55 Lakh) i.e., ₹1.10 Crore, turnover {including discontinuing operations (₹850 lakh + ₹250 Lakh)} ₹1100 Lakh i.e., ₹11 Crore.

Since its borrowings and turnover are exceeding the specified limit and therefore it is not exempt from the applicability of CARO, 2020.

35. TS Ltd. has raised funds by issuing fully convertible debentures. These funds were raised for the expansion and diversification of the business. However, the company utilised these funds for repayment of long-term loans and advances. What are the reporting requirements under CARO 2020 in this case?

Ans. Reporting Requirements under CARO 2020 for raising funds: As per clause (x)(b) of Para 3 of CARO, 2020, the auditor of a company has to report 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.

In the present case, TS Ltd. has raised funds by issuing fully convertible debentures for expansion and diversification of the business. However, the company used the funds for repayment of long-term loans and advances instead of utilisation of the same for the purpose for which the funds were raised i.e. expansion and diversification of business.

Here, the auditor should report the fact in his report that the funds were used for the purpose other than the purpose for which the funds were raised, as per cl ause (x)(b) of Para 3 of CARO, 2020.

36. State the auditor's reporting responsibilities under CARO 2016 when –

(*i*) The company has raised money by public issue.

(*ii*) The company has made private placement of shares. (PYQ Dec 2021)

Ans. Auditor's reporting responsibilities under CARO 2016:

(*i*) Clause (*ix*) para 3 of CARO, 2016 states - whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans 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.

(*ii*) Clause (*xiv*) para 3 of CARO, 2016 states - whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance.

CASE STUDY

M/s AB & Company is a firm of Chartered Accountants based in Mumbai. Mr. A and Mr. B are the Partners of the Firm. The Firm is engaged in various assignments including Audits. The partners are taking a summary of their work in order to prepare themselves to finalize the Audit and issue the audit report to various clients. You are requested to go through the following and answer the questions that follow:

- During the audit of M/s Persistent & Co, Mr. A found that the firm has changed the method of Depreciation from WDV to SLM but has not given the retrospective effect. Mr. A has calculated the difference of depreciation but M/s Persistent & Co. has stated that they don't want to change the financial statements and if auditor persists they may give the effect in the next financial year.
- During the audit of M/s Dubious Brothers, Mr B observed that the firm had a very large amount of cash sales and there were no details of the customers to whom the sales were made. Further, cash generated was not even deposited into bank regularly. When Mr. B asked the firm to give him an opportunity to count cash, the manager of the firm said that the cash is with the owner and it cannot be made available to the auditor for the checking purpose. The manager also declined to give an opportunity for stock verification to Mr B.
- During the audit of M/s Honest & Associates, Mr. A came to know that the firm has changed its method of valuation of stock. This change has a material impact on the financial statement of the firm. The firm has made relevant disclosures in the financial statements and has given proper accounting treatment to this exercise.

QUESTIONS

Theory Questions

Based on above description, answer the following questions:

37. In case of M/s Persistent & Company, what would be an ideal Audit Opinion?

(*a*) Unmodified

(*b*) Qualified

(*c*) Mention the fact in Emphasis of Matter Paragraph

(*d*) Disclaimer

Ans. (*b*)

38. In case of M/s Dubious Brothers, what Audit Opinion should the Auditor give?

(*a*) Qualified | (*b*) Adverse
(*c*) Disclaimer | (*d*) Unmodified

Ans. (*c*)

39. According to you, what would be appropriate course to take in case of M/s Honest & Associates?

(*a*) Issue Qualified Opinion
(*b*) Issue Adverse Opinion
(*c*) Mention the fact of change in method in Emphasis of Matter Paragraph
(*d*) Issue Disclaimer of Opinion

Ans. (*c*)

40. When the Auditor, after conclusion of an Audit exercise, is of the opinion that there are material misstatements in the Financial Statements, but they are not pervasive, then what should an Auditor do?

(*a*) Issue Unmodified Opinion | (*b*) Issue Qualified Opinion
(*c*) Issue Disclaimer of Opinion | (*d*) Mention it in Emphasis of Matter Paragraph

Ans. (*b*)

41. When the Auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, Auditor shall give:

(*a*) Modified Opinion | (*b*) Qualified Opinion
(*c*) Disclaimer of Opinion | (*d*) Unmodified Opinion

Ans. (*d*)

Multiple Choice Questions (MCQ)

1. While expressing an unmodified opinion on financial statements, the auditor shall not use which of the following phrases?

(*a*) present fairly in all material respects
(*b*) give a true and fair view
(*c*) with the foregoing explanation
(*d*) All of the above

Ans. (*c*)

2. ______________ is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to the user's understanding of the financial statements.

(*a*) Emphasis of Matter Paragraph
(*b*) Other Matter Paragraph
(*c*) Key Audit Matter
(*d*) Management Responsibility Paragraph.

Ans. (*a*)

3. **Statement 1:** Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements.

   Statement 2: Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.

   (*a*) Only Statement 1 is correct
   (*b*) Only Statement 2 is correct
   (*c*) Both the statements are correct
   (*d*) None of the statement is correct

Ans. (*d*)

4. Which of the following is not correct?

   (*a*) SA 700 - Forming an Opinion and Reporting on the Financial Statements
   (*b*) SA 701- Key Audit Matters in the Independent Auditor's Report
   (*c*) SA 705- Comparative Information-Corresponding figures and Comparative Financial Statements
   (*d*) SA 706- Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

Ans. (*c*)

5. Responsibilities of Joint Auditors are governed by:

   (*a*) SA 200 (*b*) SA 229
   (*c*) SA 299 (*d*) SA 230

Ans. (*c*)

❑❑❑

9 CHAPTER Special Features of Audit of Different Types of Entities

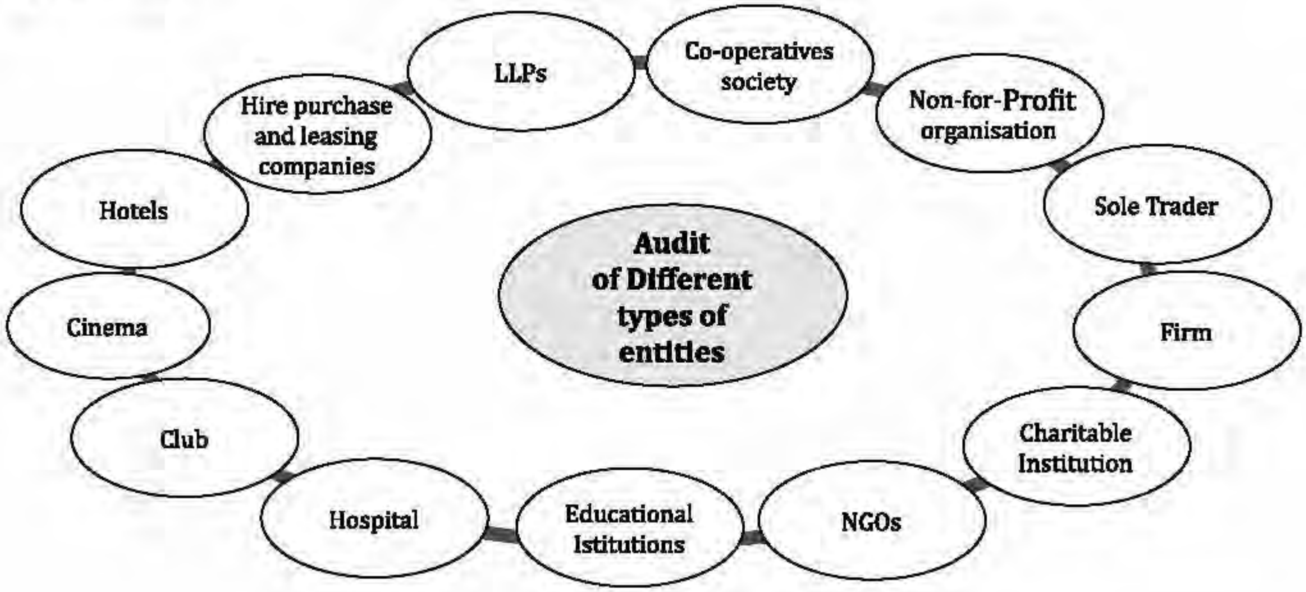
S. No.	Sub Topics	Easy	Moderate	Hard
01.	Government Audit			
02.	Background			
03.	Legal Framework and Comptroller & Auditor General			
04.	Comptroller and Auditor General's –Duties and Powers			
05.	Expenditure Audit			
06.	Audit of Receipts			
07.	Audit of Stores and Inventories			
08.	Audit of Commercial Accounts			
09.	Reporting Procedures			
10.	Audit of Local Bodies			
11.	Background			
12.	Financial Administration			
13.	Objective of Audit of Local Bodies			
14.	Audit Programme for local Bodies			
15.	Audit of Non-Governmental Organisations (NGO's)			
16.	Background			
17.	Sources and Applications of Funds			
18.	Provisions Relating to Audit			
19.	Audit of Sole Trader			
20.	Audit of Firm			
21.	Basic of Limited Liability Partnership (LLP) Audit			
22.	Audit of Charitable Institution			
23.	Audit of Educational Institutions (School, College or University)			
24.	Audit of Hospital			
25.	Audit of Club			
26.	Audit of Cinema			
27.	Audit of Hire Purchase and Leasing Companies			

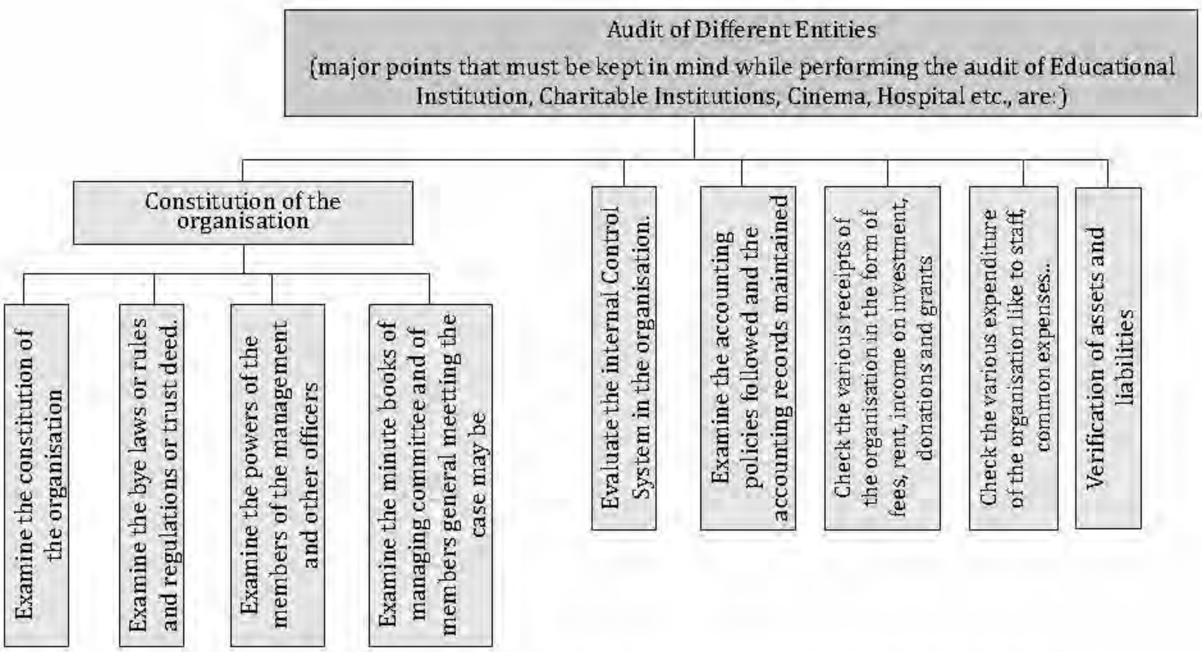
28.	Audit of Hotels			
29.	Audit of Co-Operative Societies			
30.	Background			
31.	Audit as per Section 17 of the Co-Operative Societies Act, 1912			
32.	Special Features of Co-Operative Audit			
33.	Audit, Inquiry and Inspection of Multi-State Co-Operative Societies			
34.	Audit of Trusts & Societies			

Notes to Add

Notes to Add

OVERVIEW





Notes to Add

Scrambling for his television remote one day, Sameer accidentally pushed button of "Sansad TV". Although not fond of keenly watching Parliamentary debates, his attention was drawn to pandemonium being caused in one Houses of Parliament over a report of the Comptroller and Auditor General of India (CAG). Anxious to know about importance of reports of CAG, he wanted to first know about this constitutional office. What is nature of duties of Comptroller and Auditor General of India as envisaged in Constitution of India? What makes position of CAG unique?

Astonished to learn that Comptroller and Auditor General is known as "Supreme Audit Institution of India", he wanted to know more about scope of duties performed by such an important institution. Not only audits of receipts and expenditure of Union of India and States are performed by CAG of India, this institution is also responsible for audit of receipts and expenditure of bodies mainly financed by Union or State Revenues.

Besides above, it is responsible for ensuring that public funds are being collected and used effectively and efficiently. Does CAG have a role to play in audits of government companies? What are law provisions in this regard? He was also thinking that Constitution must have included provisions to ensure independence of such an institution. What are such provisions?

Knowing importance of local bodies governing cities, Sameer also wanted to know how control over expenditure of local bodies is exercised. Who exercises such control and what are main objectives of such an audit? How financial administration of such urban local bodies is run?

Are there some other sets of entities which merit special audit considerations by virtue of their nature or structure? For example, an NGO works in a totally different environment. It may work in social or environmental areas. What critical points are to be kept in mind by auditor of an NGO? Similarly, clubs, hotels and hospitals may involve audit considerations peculiar to their nature of working.

Sameer had also noticed sign boards of some organizations with LLP written at the end. What does it denote? How does it differ from a partnership firm? What are regulatory requirements in respect of LLP? As an auditor, what special considerations apply in case of audit of LLP?

Notes to Add

GOVERNMENT AUDIT

BACKGROUND

(1) Government Audit

Revenue | Expenditure

↓

Control

Parliament | State Legislature (SL)

Insistence up on Grant

- No expenditure can be incurred → unless voted up on by

  Parliament | State Legislature (SL)

- Funds for such expenditure must be provided out of 'consolidated Fund of'

  India (CFI) | State (CFS) | Union Territory with Legislative Assembly (CFUT + LA)

- After expenditure is incurred + A/c. are closed

  ↓

  Appropriation A/c. are prepared

  ↓

  Scrutinized by 'Public Accounts Committee' (PAC)

- Initially → Govt. Audit was → Expenditure oriented

  Gradually → Audit of Receipts was taken up

- With rapid growth of public Enterprises → 'Commercial Audit' Came into Being
- Large no. of Non-commercial autonomous Bodies → Field of

  Development | Academic | Scientific | Social Research

  Financed by Govt.

  ↓

  Required to be Audited

  - Definition → Govt. Audit ← U.N. Handbook

    Objective | Systematic | Professional | Independent

    Examination

    Financial | Administrative | Other

    Operations

    ↓

    Of Public entity

↓

Made subsequently → To their execution

↓

For the purpose — Evaluating / Verifying

↓

Presenting

Report | Explanatory Comments | Audit findings | Conclusions | Recommendation

By Responsible officials

- Objective of Govt. Audit
  - Accounting for Public funds
  - Appraisal of Govt. Policies
  - Base for corrective Action

- Main objectives of Govt. Audit
  - Ensuring Accountability ↓ of Administration ↓ To legislative
  - Functioning as an ↓ Aid to Administration

- Administrative Accountability

Govt. is — Neither equipped / Nor Intended — To → function is an → investigative Agency

↓

To pursue every irregularity or misdemeanour

The Comptroller & Auditor General (Duties, Powers & Conditions of Services) Act, 1971

- Govt. Audit → Conducted by → Independent Statutory Authority

↓ In India ↓ The controller & Auditor General of India (C & AG)

↓

Through → The Indian Audit & Accounts Department

↓ ↓

in accordance with

- Constitution of India
- Laws made by Parliament
- Rules & Orders

Government Audit is as old as organised governments and has fairly long pedigree even in developing countries. The concept, content and scope of government audit have developed in tune with the political, social and economic development of the countries. It has also responded to the needs of the administration. It aims to ensure accountability of the executive in respect of public revenue and expenditure. Primarily, the Parliament and in case of States, the State legislatures control all government expenditure through insistence upon demand for grants. The main idea underlying this control is that no expenditure can be incurred unless it has been voted upon by the Parliament or State Legislatures and funds for every such expenditure must be provided from out of the Consolidated Fund of India or of the State.

(As per Article 266, the Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India)

After the expenditure has been incurred and the accounts are closed, the Appropriation Accounts are prepared which are scrutinised by the Public Accounts Committee (The Public Accounts Committee (PAC) is a committee of selected members of parliament, constituted by the Parliament of India, for the purpose of auditing the revenue and the expenditure of the Government of India). Thus, Parliamentary or Legislative control is exercised before spending and after the expenditure is actually incurred.

Since independence there has been a tremendous spurt in governmental activities with the attendant increase in expenditure, revenue and capital, and in receipts and borrowings to match the expenditure. Government has entered the business field and government in business is not the same as government administering law and order and attending to regulatory functions.

Independent India witnessed a steady growth of state commercial enterprise. The change in the character of government and the complex nature of its activities, including regulatory functions in an international environment called for a change in the nature and scope of audit. Audit has evolved from accountancy and regularity check to evaluation of the end results of the operations of government.

Initially, government auditing in India as elsewhere was primarily expenditure- oriented. Gradually, audit of receipts-tax and non-tax was taken up. With the rapid growth of public enterprises, another major area of specialisation, i.e., commercial audit, came into being. There are also a large number of non-commercial autonomous bodies financed by government in diverse fields of development and of academic study and scientific or social research which are also required to be audited from the viewpoint of public accountability.

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession.

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government auditing is

- 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 containing explanatory comments on audit findings together with conclusions and recommendations for future actions
- by the responsible officials
- and in the 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 officials 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 officers to take corrective measures.

Administrative accountability: Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration. 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. 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. 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.

Notes to Add

LEGAL FRAMEWORK AND COMPTROLLER & AUDITOR GENERAL

- Appointed by → The President of India
- Shall not be Removed Except → on proven → misbehaviour → incapacity

  ↓

  > 2/3 Majority → of Both houses of Parliament → Present & Voting
- After appointment → salary cannot be varied

  ↓

  To his disadvantage
- Salary = Supreme Court Judge
- President to Consult C & AG → for appointing any person in Indian Audit & Accounts Department → for deciding Administrative Power of C & AG
- **Article 149** → of the constitution of Indian → Gives powers to C & AG
  - The C & AG (Duties, Powers & Conditions of Service) Act, 1971 → Defines the powers
- **Article 150** → Format of Accounts of Union & States→ Decided by President → Advice of C&AG
- **Article 151** → C & AG to provide Report an A/c. → Submitted to

President | Governor

They Will laid before

House of Parliament | State Legislature

Notes to Add

The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C&AG.

(1) Appointment & Removal: The Constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity. As in the case of a Judge of the Supreme Court, he can be removed only when each House of Parliament decides to do so by a majority of not less than 2/3rd of the members of the House present and voting. The Parliament is competent to make laws to determine salary and other conditions of service and they cannot be varied to his disadvantage after his appointment.

The Constitution further provides that the conditions of service of person serving in the Indian Audit and Accounts Department and the administrative powers of the C&AG shall be determined by the President after consultation with him.

(2) Tenure: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 passed in pursuance of the provisions of the Constitution lays down a fixed tenure of the office prescribing that he shall be paid a salary which is equal to the salary of the Judge of the Supreme Court thereby further strengthening his independence.

(3) Various Constitutional Provisions

(*i*) 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.

(*ii*) 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.

(*iii*) 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.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

1. Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the Finance Minister may on the advice of the C&AG prescribe.

Ans. Incorrect: 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.

Notes to Add

COMPTROLLER AND AUDITOR GENERAL'S — DUTIES AND POWERS

Duties of C & AG (7 Duties)

(i) Compile + Submit → A/c.'s of Union + State

Rendered to Audit & Accounts Officers → From Initial & Subsidiary A/c.

- Treasury
- Offices
- Departments

Show Annual

- Receipts
- Disbursements

of

- Union ↓ President
- State ↓ Governor
- UT with LA ↓ Administrator of UT

→ As per the Act → It is not the responsibility of C&AG → to → Give Info. → Prepare A/c.

(ii) General Provisions Relating to Audit Report

- All expenditure from CFI / CFS / CFUT + LA + Ascertain whether
  - Money shown having been disbursed ↓ Were legally available for + Applicable to ↓ To which they have been appled
  - Expenditure ↓ Conforms the authority ↓ Which governs it
    - Service
    - Purpopse
- All transactions of Union+State ↓ Relating to
  - Contingency Fund
  - Public A/c.
- FS & Other Subsidiary A/c. ↓ Kept in any department of
  - Union
  - State

(iii) Audit of Receipts & Expenditure

Where any — Body / Authority — is substantially financed Grant/Loan

↓

By Grants/Loans

↓

From CFI/CFS/CFUT+LA

≥ ₹ 25,00,000/-

and

≥ 75% of total expenditure of Body/Authority

C & AG — Audit / Report — Receipts + Expenditure

Eg: College Loan = ₹ 76,0 0,000/-
Substantially Financed ↓
Total Expenditure ₹1,00,00,000/-

(iv) Audit of Grants / Loans → for specific purpose → from CFI/CFS/CFUT + LA

↓

to any authority / body → NOT — Foreign state / International organisation

C&AG

- Scrutinize the procedure
  ↓
  By which sanctioning Authority
  ↓
  Satisfies itself as tofulfilment of conditions
- Have a right of access
  ↓
  By giving prior notice
  ↓
  Books of A/c
  ↓
  of that Body / Authority

(v) Audit of Receipts of Union + State + Satisfies himself that → Rules & Procedures
→ Designed to secure an effective check on

Assessment / Collection / Allocation

of Revenue

(vi) Audit of A/c's of stores & Inventories

(1) Regulations Governing — **Purchase / Receipt / Issue** — **of** — **Custody / Sale / Inventory taking** — **of Stores**

+

Devised & Properly Carried out

(2) Aim is to bring In any deficiencies in — **Quantities of stores held / System of Control**

(3) Ensures
- Prices paid are reasonable +in agreement → with those shown in contract
- Certificates of
  - Quality
  - Quantity

  By
  - Inspecting
  - Receiving

  Units

(4) Periodical Verification

(vii) Audit of Govt. Co. & Corporations

- **→ In accordance with The Companies Act, 2013**
- **→ Appoint Auditor u/s. 139(7) & 139(5)**

Notes to Add

The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 defines functions and powers in detail. The relevant provisions are discussed hereunder—

Duties of the C&AG:

(i) Compile and submit Accounts of Union and States: The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. The Comptroller and Auditor General shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

NOTE: The C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to the Union and States: The Comptroller and Auditor General shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

(ii) 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 governsit;

(*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.

(iii) Audit of Receipts and Expenditure: Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

Meaning of Substantially financed: Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly in a financial year is not less than ₹25 lakhs and the amount of such grant or loan is not less than 75% of the total expenditure of that body or authority, such body or authority shall be deemed, for this purpose to be substantially financed by such grants or loans as the case may be.

(iv) Audit of Grants or Loans: 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 having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise 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.

(v) Audit of Receipts of Union or States: It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) Audit of Accounts of Stores and Inventory: The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(vii) Audit of Government Companies and Corporations: The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The Comptroller and Auditor- General of India shall appoint the auditor under section 139(5) or 139(7) (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

Notes to Add

Notes to Add

POWERS OF C & AG

(i) To Inspect → any office → under the control of → Union + State
↓
Including office responsible for creation of → Initial & Subsidiary A/c

(ii) To require any — Accounts / Books / Papers / Documents — relevant to audit → to be sent to specified places

(iii) To — put such questions / make such observations — he may consider necessary

(iv) Power to → dispense with → any part of detailed audit of A/cs and CoT

Notes to Add

Powers of C&AG

The C&AG Act gives the following powers to the C&AG in connection with the performance of his duties-

(a) 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.

(b) 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.

(c) 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.

(d) In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

2. The Comptroller and Auditor General does not have any authority to audit the accounts of stores and inventory kept in any office or department of the Union or of a State.

Ans. Incorrect: The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

Theory Questions

3. Explain in detail the duties of Comptroller and Auditor General of India.

Ans. Duties of C&AG: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under-

(i) **Compile and submit Accounts of Union and States -** The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

(ii) **General Provisions Relating to Audit - It shall be the duty of the C&AG –**

(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 profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) **Audit of Receipts and Expenditure -** Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union

Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

(*iv*) Audit of Grants or Loans - 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 having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise 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.

(*v*) Audit of Receipts of Union or States - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

(*vi*) Audit of Accounts of Stores and Inventory - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(*vii*) Audit of Government Companies and Corporations - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor- General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

4. In case of Government entities, audit of accounts of stores and inventories has been developed as a part of expenditure audit. Discuss about the duties and responsibilities entrusted to C&AG.

Ans. Audit of Accounts of Stores and Inventories in Government Companies:

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:

(*i*) To ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.

(*ii*) To bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.

(*iii*) To verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.

(*iv*) 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.

(*v*) 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. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time.

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.

Notes to Add

EXPENDITURE AUDIT

The basic standards → Set to ensure → provision or funds

↓

Authorised bv competent authority

↓

Fixing limit within which → Expenditure can be incurred

(i) Audit against Rules & orders

Expenditure incurred → conforms
- **Relevant provisions of statutory enactments**
- **Financial rules & Regulations formed by competent authority**

→ Quasi-Judicial work → involves → interpretation
- Constitution
- Statues
- Rules
- Regulations
- Orders

→ Final power → interpretation ≠ C&AG

→ Categories
- Rules
- Regulation
- Orders

Categories:
- Power
  - incur
  - Sanction
  - Expenditure
    - CFI
    - CFS
    - CFUT+LA
- Presentation → Claims
  + Withdrawl
    - Consolidated Fund
    - Contingency Fund
    - Public A/c
- Govt. Servants
  - Condition of Service
  - Pay
  - Allowances
  - Pensions

→ Executive Authorities → To see
- Rules
- Regulations
- Orders

Rules, Regulations, Orders:
- Not Inconsistent
  - Prov. Of Constitution
  - Laws
- Not In Conflict
  ↓
  Orders / Rules
  ↓
  Higher Authorities
- Not Separately approved
- Consistent
  ↓
  Essential Req.
  - Audit
  - A/cs

(ii) Audit of Sanctions

There is Sanction → accorded by → competent authority

General | Specific

(iii) Audit against provision of funds

There is provision of funds → out of which expenditure can be incurred

Authorized by competent authority | Amount does not exceed appropriation

(iv) Propriety Audit

Expenditure incurred → with due regard to – Broad / General – Principles of → Financial Propriety

→ Expenditure

- **Not > Occasion demands**
- **As officer's own money**
- **Not to own advantage**
- **Not for benefit of a particular**
  - **Person**
  - **Community**

unless

- **Insignificant amount**
- **Claim could be Enforced in court**
- **As per recognised**
  - **Policy**
  - **Custom**
- **Not source of Profit to recipient**

+

Regularity Audit → alone not suff.

(v) Performance Audit / Full Scope Audit

- Eficiency Audit
  - Schemes | Programs
  - Execution | Operation
  - Running Economically | Yielding Results
- Economy Audit
  - ↓ Govt. acquired
  - ↓ Resources
  - Economical Manner | Sanctioning + Spending ↓ Authority ↓ Observed economy
- Effectiveness Audit
  - ↓ Appraise
  - Programs | Projects | Schemes
  - Target objective + Eficiency
- Eficiency cum Performance Audit
  - ↓ Objective Examination
  - ↓ Performance
  - ↓ Greater
  - Economy | Effectiveness

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.

Each of the above audits is discussed in detail in the following paragraphs.

1. **Audit against Rules & Orders:** Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. 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.

   These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

   (*i*) 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);

   (*ii*) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingencyt 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

   (*iii*) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

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.

But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

(*a*) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;

(*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.

2. **Audit of sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. 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.
3. **Audit against provision of funds:** Audit against provision of funds aims at ascertaining that the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made.
4. **Propriety audit:** 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. 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. 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. e.g.:- 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.

   Audit should, therefore, try to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions. These considerations have led to the evolution of audit against propriety which is now being combined by the audit authorities with their routine function of regularity audit. 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.

   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

- Audit against Rules & Orders: The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.
- Audit of Sanctions: The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure.
- Audit against Provision of Funds: It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.
- Propriety Audit: To ensure compliance with general principles of financial propriety and to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in Conformity with the existing rules and regulations.
- Performance Audit: This 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.

Notes to Add

5. 1 7. The audit of Government expenditure is one of the major components of Government audit. Briefly explain the basic standards set in relation to audit of Government expenditure.

Ans. 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 authorized by competent authority fixing the limits within which expenditure 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 & 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.

Notes to Add

AUDIT OF RECEIPTS

(i) All — Revenue / Debts — Due to Govt. → Correctly — Assessed / Realised / Credited

(ii) Adequate — Regulations / Procedures — Have been framed

(iii) Such — Regulations / Procedures — Actually been carried out

(iv) Adequate checks are imposed

(v) Review of — Systems / Procedures

Notes to Add

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;

(i) whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;

(ii) 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;

(iii) whether such regulations and procedures are actually being carried out;

(iv) whether adequate checks are 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

(v) 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. The basic principle of audit of receipts is that it is more important to look at the general than on the particular, though individual cases of assessment, demand, collection, refund, etc. are important within the area of test check. A review of the judicial decisions taken by tax authorities is done to judge the effectiveness of the assessment procedure.

(vi) 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. 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. Institutional mechanism provides for primary check by the auditor, test check by the supervisor and control and direction by the group leader. Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy. There are built-in arrangements within the C&AG to ensure that the work assigned to each employee is carried out as prescribed. The audit is conducted both centrally where accounts and original vouchers are kept and locally where the drawing and disbursing functions are performed depending on the organisational and institutional arrangements obtaining.

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 :-

- to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.
- to bring to the notice of the government any deficiencies in quantities of
- stores held or any defects in the system of control.
- to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.
- 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.
- 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. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. 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 COMMERCIAL ACCOUNTS

Categories

- **Departmental Enterprises** → Engaged in commercial / trading activities → Subject to same laws, financial & other regulations as other Govt. Dept agencies → Audit is undertaken in the same manner as any Dept. of Govt. where commercial A/c. are kept
- **Statutory Bodies, Corporations** → Created by specific statutes → Mostly financed by Govt. → In form of loans & Advances → Audit depends upon nature & type of statutes
- **Govt. Co.** → Under the companies Act, 2013 → Have their own auditor appointed by C & AG

C & AG conducts → Test Audit of + Periodical financial Audit + Performance Audit + Issue direction to Co. Auditor

In case of Govt. Co →C & AG shall have right to → Within 60 Days → Receipt of Audit Report

- **Conduct supplementary Audit u/s 143(6)(a)** → **FS of the Co.** → **By such person(s) he may authorize** → **Require Info.**
- **Comment up on / Supplement** → **Such audit report u/s 143(6)(b)** → **To be sent by Co. to**
  - **Member**
  - **Trustee**
  - **Anyone entitled to AGM**
- **Test Audit** → **C&AG can cause Test Audit**

Notes to Add

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 government companies set up under the Companies Act, 2013.

The audit of :-

- **Departmental concerns** is undertaken in the same manner as any department of government where commercial accounts are kept.
- **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.
- **Government companies** 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. 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. 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.

Role of C&AG is prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013.

(1) Power to appoint Government Company Auditor: Section 143(5) of the Act states that, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of th e Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

Itor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of th e Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

(2) Power to conduct Supplementary Audit & comment thereupon:- The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to, (*a*) conduct a **supplementary audit under section 143(6)(a),** of the financial statement of the company by such person or persons as he may authorize 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 Comptroller and Auditor-General of India may direct; and

(*b*) **comment upon or supplement such audit report under section 143(6)(b)**. Any comments given by the 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 of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

(3) Test Audit: 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.

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.

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.

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.

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.

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.

Notes to Add

REPORTING PROCEDURES

→ Reporting Procedure → As per article 151 → C & AG shall report on A/c.

Union → President of India | State → Governor

Publish Report in Legislature + Newspaper (Generally) + Create a climate for public Opinion

Notes to Add

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. 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. 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. 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.

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.

Test Your Understanding

1. It is the duty of Comptroller and Auditor General of India 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. Discuss, in above context, what is understood by "Consolidated Fund of India"? What is its importance?

Ans. Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India. Its importance lies in the fact that all government expenditure is incurred from this fund. No moneys out of the Consolidated Fund of India shall be appropriated except in accordance with law and for the purposes and in the manner provided in the Constitution.

Notes to Add

AUDIT OF LOCAL BODIES

Background

Definition → Municipality → Local self Govt. → Urban areas

Municipal Authorities (MA)

- Municipal Corporations ↓ Tax powers ↓ Limited to few items
- Municipal Councils
- Notified Area Committee
- Town Area committee
- Cantonment committee

(Municipal Councils, Notified Area Committee, Town Area committee, Cantonment committee) Wider range → Optional in nature + subject to procedure → requiring SG Sanctions

Functions of MA
- Regulatory
- Maintenance
- Development

Expenditure incurred by MA
- General Administrative & Revenue Collection
- Public Health
- Public Safety
- Education
- Public Works
- Others ↓ Such as Interest Payment

Revenue

Property Tax, Octroi, Profession Tax, Non-Mechanised Vehicle Tax, Taxes on Advertising, Taxes on animals & Boats, Tolls, Show-Tax, etc.

Types of Grants
- General Purpose Grant ↓ Bridges gap b/w → Needs → Available Resources
- Specilc purpose Grant
- Statutory & Compensatory Grant → On A/c. of loss of revenue on taking over a tax by SG

Notes to Add

(1) **A Municipality** can be defined as a unit of local self-government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

The discussion in following paragraphs is based on an article "Audit of Municipal Administration" by R. Chandra Sekharan.

By 1947, the year of independence of India, most of the urban and semi-urban areas had been constituted into municipalities of one kind or another. Among them were the premier corporations of Mumbai, Chennai and Kolkata each with a special kind of constitutional structure, better financial resources and subject to less state control than other municipal bodies. The service which the local bodies had to render was restricted to education, public health, sanitation, medical relief, roads and a few public works. This was so because these bodies were considered to be inefficient and they lacked adequate financial resources. These bodies derived their revenues from a number of sources – taxes on property, taxes on trade, taxes on persons; fees and licences, non- tax resources such as rent of land, houses, income from commercial undertakings; government grants, etc.

(2) **Municipal government in India covers five distinct types of urban local authorities-**

- the municipal corporations,
- the municipal councils,
- the notified area committees,
- the town area committees and
- the cantonment committees.

(3) **Municipal authorities are endowed with specific local functions covering**

(*a*) regulatory,

(*b*) maintenance and

(*c*) development activities.

(4) **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.

(5) **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. 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.

(6) 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.

QUESTIONS

Theory Questions

8. CA Sevak is appointed as an auditor of a Municipal Corporation of a big smart city. He wants to verify various expenditures of the Municipality.Define the term "Municipality" and state what are the heads under which expenditures incurred by the Municipalities and Corporations can be broadly classified?

Ans. Definition of Municipality & Expenditure incurred by it: Definition: A Municipality can be defined as a unit of local self-government in an urban area. By the term 'local self- government' is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services 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.

Notes to Add

Notes to Add

FINANCIAL ADMINISTRATION

Financial Administration

To be familiar with → in order to plan an audit

(1) Budgetary Procedure → Consider → Financial Accountability + Control of Expenditure

→ Main Objective → funds are raise + Money is spent

By Executive department

In accordance with Rules & Regulations + Limit of sanction + Authorization

+

No strict separation b/w **Revenue** / **Capital** items

↓

Under 'Extraordinary Items' head

(2) Expenditure Control → Clear demarcation SG / CG

Legislature | Executive

Integration → Municipal Council

↓

External Audit by SG because

Diff. to function

↓

As inquisitorial body

Cannot accommodate

↓

Independent Finance Officer

(3) Accounting System→Municipal Accounting / Budget Formats

↓

CRITICISED

Neither simple | Nor Comprehensible

Sometimes Provides

Inadequate | Surfeit

Info

It would be imminent on the part of the auditor to understand financial administration of local bodies before embarking upon the audit. Some of the aspects are as under:

(a) Budgetary Procedure: This is geared to subserve the twin considerations of financial accountability and control of expenditure. 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 the legislature or council. Budget preparation is usually the occasion for determining the levels of taxation and rates and the ceilings on expenditure.

Municipal budget formats and heads of accounts vary from state to state. There are variations between the corporation and municipalities. 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. 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.)

(b) Expenditure Control: 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. 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.

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. This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.

(c) Accounting System: 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. Both these situations are not conducive to a proper system of managementinformation.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

9. 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.

Ans. Incorrect: 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.

10. The external control of municipal expenditure is exercised by the Central Government through the appointment of auditors to examine municipal accounts.

Ans. Incorrect: The external control of municipal expenditure is exercised by the Central Government through the appointment of auditors to examine municipal accounts.

OBJECTIVE OF AUDIT OF LOCAL BODIES

→ Objective of Audit

- Reports on
  - The fairness + Content + Presentation of F.S.
  - Strength + Weakness of system of financial control
  - Adherence to Legal / Administrative Requirements
  - Whether Value is being fully received on money spent
- Detection & Prevention of F/E & Misuse of resources

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.

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.

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. This procedure is a legacy of colonial days and even in England it is being resorted to less and less. This may well be because of the increasing competence of the local government authorities.

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. 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.

As described under government audit above, 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').

QUESTIONS

Theory Questions

11. State the important objectives of Local bodies Audit.

Ans. Objective of Audit of Local Bodies: The important objectives of audit of local bodies 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.

Audit Programme for local Bodies

(1) Smaller Municipal Authority → Local fund Audit wing → of SG → is generally incharge of Audit of Municipal A/c.
Bigger Municipal Authority → have power to appoint their own auditor

(2) Auditor to report on

- Fairness + Content + Presentation of F.S
- Strength + Weakness of System of Financial Control
- Expenditure incurred conforms
  - Relevant Provisions of Laws
  - Rules & Regulations framed
- Sanctions accorded by competent authority
- Provision of funds + Expenditure is incurred from it + authorized by competent authority
- Different schemes + Programmes + Projects ↓ Running economically ↓ Yielding results

Notes to Add

(i) 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.

(ii) AUDITOR'S CONCERNS: The auditor while auditing the local bodies should report on the

- fairness of the contents and presentation of financial statements,
- the strengths and weaknesses of system of financial control,
- the adherence to legal and/or administrative requirements;
- whether value is being fully received on money spent.
- His objective should be to detect errors and fraud and misuse of resources.

(iii) 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.

(iv) AUTHORISATIONS: He should ensure that all types of sanctions, either special or general, accorded by the competent authority.

(v) 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.

(vi) 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.

QUESTIONS

Theory Questions

12. Local Fund Audit Wing of a State of a State Government has appointed you to audit the accounts of one of the Local body governed by it. As an auditor, what will be your reporting areas?

Ans. Reporting areas in audit of Local Fund:

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.

(*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.

Notes to Add

AUDIT OF NON-GOVERNMENTAL ORGANISATION (NGO'S)

Background

Audit of NGO's

Registration:

1. No act warrants a Mandatory Registration under them
2. NGO can be incorporated under

- The Societies Registration Act, 1860
- The Indian Trust Act, 1882
  ↓
  Additional Acts if Registered as a trust → Immovable property > ₹ 100
  - The Registration Act, 1908 (Sec.17(1))
  - The of Property Act, 1882 (Sec.123)
- The Companies Act, 2013
  ↓
  Sec.8
  ↓
  Books as per Accrual system of Accounting

The Income Tax Act, 1961 + The Foreign Contribution (Regulation) Act, 1976

Notes to Add

(1) NGOs can be defined as non-profit making organisations 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 situations.

(2) Therefore, this definition of NGO would include religious organisations, voluntary health and welfare agencies, charitable organisations, 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. Some examples of NGOs operating in India include Child Relief and You (CRY), NORAD, UNICEF, Godhuli, Vidya, Concern India Foundation., etc.

CRY CHILD RIGHTS AND YOU www.cry.org

VIDYA BE THE GUIDING STAR

CONCERN® INDIA FOUNDATION HELPING PEOPLE HELP THEMSELVES

(3) 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. NGOs can also be incorporated as a company under section 8 of the Companies Act, 2013. 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. 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.

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. The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either an accrual basis or cash basis.

Notes to Add

....

....

....

SOURCES AND APPLICATIONS OF FUNDS

Sources ← of Funds → Application

Sources

↓

(1) Promoter's Contribution

↓

Either

- Corpus Contribution → Capital + Voluntary → With Specific direction
- Revolving Fund → Temp. Loan

(2) Contribution in kind

Application

↓

(1) Est. Cost
(2) Office & Administration
(3) Maintenance
(4) Prog.
(5) Project
(6) Charity, etc.

Notes to Add

(1) 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.

(*a*) 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. 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.

(*b*) 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.

(*c*) 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. 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.

(*d*) 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.

(*e*) Many a times NGOs receive contributions in kind. These contributions include assets such as land, buildings, vehicles, office 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.

(2) The areas of application of funds for an NGO include Establishment Costs, Office and Administrative Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations and Contributions given, etc.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

13. NGOs may be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives.

Ans. Incorrect: NGOs may be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives.

Theory Questions

14. An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations. (ICAI Study Material)

Ans. (*d*) Receipt of Donations:

(*i*) Internal Control System: Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.

(*ii*) Custody of Receipt Books: Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.

(*iii*) Receipt of Cheques: Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official.

All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

(*iv*) Bank Reconciliation: Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.

(*v*) Cash Receipts: Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.

(*vi*) Foreign Contributions, if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of Donations to Different NGOs:

- **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.
- **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.
- **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.
- **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.
- **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.
- **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.

Notes to Add

Notes to Add

PROVISIONS RELATING TO AUDIT

Auditor of NGO → Registered under

The Societies Registration Act, 1860
OR
The Indian Trust Act, 1882
↓
Appointed Mgt. of Society / Trust

The Companies Act, 2013
↓
Sec.8
↓
Appointed by Members of Co.

Compulsory Audit as per :-

- The Companies Act, 2013
- The Foreign Contribution (Regulation) Act, 201 0 → Prescribed format
  ↓
  Ministry of Home Affairs →30 May
- The Income Tax Act, 1961
  - NGO
  - Private Development Assistance (PDA)

Audit has to Consider

(i) Knowledge
Work
Mission
Vision
Area of Operation
— **of NGO**

(ii) Updated knowledge of relevant statutes
(iii) Legal form of organisation → Review
(iv) Examination of Minutes of Meeting
(v) Study Accounting System
(vi) Set Materiality
(vii) N.T.E. of Report

Notes to Add

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. The auditors of NGO registered under section 8 of the Companies Act, 2013 are appointed by the members of the company. Some of the statues such as the Companies Act, 2013, Foreign Contribution (Regulation) Act, 2010, 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 different statutes have specified certain audit reports. The Foreign Contribution (Regulation) Act, 2010 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:

(*i*) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.

(*ii*) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 2010, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.

(*iii*) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.

(*iv*) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.

(*v*) 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.

(*vi*) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

(*vii*) Setting of materiality levels for audit purposes.

(*viii*) The nature and timing of reports or other communications.

(*ix*) The involvement of experts and their reports.

(*x*) 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.

(*i*) 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.

(*ii*) Reserves: Vouch transfers from projects / programmes with donors 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.

(*iii*) 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 donors institutions, board resolution of NGO, rules and regulations of the schemes of the ear- marked funds.

(*iv*) Project / Agency Balances: Vouch disbursements and expenditure as per agreements with donors for each of the balances.

(*v*) Loans: Vouch loans with loan agreements, counterfoil of receipt issued.

(*vi*) **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.

(*vii*) **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.

(*viii*) **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.

(*ix*) **Bank Balance:** Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

(*x*) **Inventory:** Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.

(*xi*) **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.

(*xii*) **Establishment Expenses:** Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed & deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

The receipt of income of NGO may be checked on the following lines:

(*i*) **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, 2010.

(*ii*) **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.

(*iii*) **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.

(*iv*) **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.

(*v*) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

Notes to Add

QUESTIONS

Theory Questions

15. You have been appointed as an auditor of an NGO, briefly state the points on which you would concentrate while planning the audit of such an organisation?

Ans. (*a*) While planning the audit of an NGO, the auditor may concentrate on the following:

(*i*) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.

(*ii*) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions related to the statutes.

(*iii*) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.

(*iv*) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.

(*v*) 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.

(*vi*) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

(*vii*) Setting of materiality levels for audit purposes.

(*viii*) The nature and timing of reports or other communications.

(*ix*) The involvement of experts and their reports.

(*x*) Review the previous year's Audit Report.

Notes to Add

AUDIT OF SOLE TRADER

Audit of Sole Trader

(i) Under No Legal obligation to appoint auditor
(ii) Audit due to Regulatory Requirements → Like Bank Loan, Stock Audit etc.
(iii) Proprietor can determine → Scope → Conditions → of audit
(iv) Auditor to communicate with previous auditor
(v) Contract of Appointment → Desirable → To prevent misunderstanding

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.

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.

Example: He can stipulate that only a partial audit shall be carried out, that certain parts of the accounts shall not be checked or that the auditor also shall prepare the final statements of account. He can also decide whether the audit shall be carried out continuously or at the end of the year.

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. 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.

The advantages and audit procedure discussed in following paragraphs of audit in case of partnership firm would be similar in case of proprietorship.

Notes to Add

Notes to Add

AUDIT OF FIRM

Appointment→Auditor + His Remuneration + Nature + Scope of Audit

To be decided by the partners

→ In writing → Via Letter of Appointment (LoA)

→ Communication with previous auditor

→ Ensure → application of AS → If AS not applied

- Compulsory audit ↓ Qualified Audit Report
- Voluntary Audit ↓ Disclosure of Non-Compliance in Audit Report

→Matters to be Considered

BEFORE AUDIT	DURING AUDIT
1) Name, Style → Business 2) Duration 3) Amount of Capital 4) Year end? 5) Borrowing Capacity 6) Capital, Loan → Interest Rate 7) Salaries 8) Managing Partner } PARTNERSHIP DEED	(1) Confirming (LoA) → Signedby partner → Duly authorized ↓ State: Scope, Nature, Limitation (2) Study the minutes (3) Verification of T&C of agreement partnership (4) Examining Books of A/c's (5) Verifying that interest of no partner has suffered (6) Provision for Tax has been made (7) Verifying P/L → Divided in Proper Ratio

Advantages of an Audit firm

- Provides
  - Convenient
  - Reliable
  - Means of settling A/c's
    - Dispute
    - Admission
    - Bank Loan
    - Death / Retirement
- Effective Safeguard ↓ Against ↓ Under advantage being taken ↓ By working partner

Appointment of Auditors: 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. His remuneration is also fixed by the partners. 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. In case of change of auditor, it would be duty of incoming auditor to communicate with the previous auditor.

The auditor may, particularly, ensure application of accounting standards prescribed by the Institute of Chartered Accountants of India. 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. Alternatively, only disclosure of non- compliance with the accounting standards, would be sufficient without making it a subject matter of qualification.

Matters to be considered before starting audit: Also, before starting the audit, he should examine the partnership agreement and note the provisions therein as regards the following matters:

(1) The name and style under which the business shall be conducted.

(2) The duration of the partnership, if any, that has been agreed upon.

(3) The amount of capital that shall be contributed by each partner—whether it will be fixed or could be varied from year to year.

(4) 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.

(5) 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.

(6) Borrowing capacity of the partnership (when it is not implied as in the case of non-trading firms).

(7) 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.

(8) Whether any salaries are payable to the partners or withdrawals are permitted against shares of profits and, if so, to what extent?

(9) Duties of the partners as regards the management of business of the firm; also, the partners who shall act as managing partners.

(10) Who shall operate the bank account of the firm? How will the surplus funds of the partnership be invested?

(11) 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:

(1) 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.

(2) **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.

(3) **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.

(4) **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.

(5) **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:

(i) **Letter of Appointment:-** Confirming that the letter 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.

(ii) **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.

(iii) **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.

(iv) **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.

(v) **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.

(vi) **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.

(vii) **Division of Profits:-** Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

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 affairs of the firm.

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.

Test Your Understanding

2. CA Akash Virmani is auditor of a partnership firm consisting of 4 partners. During the year, one of the partners has retired and another partner has joined the next day. Discuss, any one point, which shall be considered by you to ensure that financial statements of firm are not misstated due to change of constitution of firm.

Ans. The auditor shall consider provisions of retirement deed/partnership deed for date of retiring and joining of partners. It should be ensured that profits are appropriately distributed up to date of retirement. Further, profits after retirement should have been distributed among partners as per terms of new partnership deed.

Notes to Add

BASICS OF LIMITED LIABILITY PARTNERSHIPS (LLP) AUDIT

Definition → Small LLP

Partner's Capital [Contribution] ↓

Turnover ↓

Partner's Capital [Contribution]				Turnover
≤ ₹ 25,00,000	←	[Present]	→	≤ ₹ 40,00,000
≤ ₹ 5,00,00,000	←	[May be prescribed by CG] Max Limit ↓ In Future	→	≤ ₹ 50,00,00,000

→ Books of A/c's of LLP

(i) Details of money → Received → Expended

(ii) Details of Assets + Liabilities

(iii) Statement of → WIP → FG → Inventories → COGS

- **Cost of Goods Purchased**
- **WIP**
- **FG**
- **Inventories**
- **COGS**

(iv) Other particulars which partners may decide

Audit of A/cs of LLP

- **Compulsory Audit** ↓ **As per rule 24 of LLP Rules, 2009** ↓ **T/o > ₹40 lakhs Contribution > ₹25 Lakhs**
- **Voluntary Audit** ↓ **To be conducted as per Rules**

Advantages/Purpose/Need of Audit

- **Detection of errors**
- **Disputes**
- **Reliability**
- **Compliance & Mgt.**
- **Reconstitution**

Returns to be maintained and filed by an LLP :-

Prepare → Statement of Accounts & Solvency (SAS)

↓

In prescribed form → Form 8

↓

File with RoC every year → 30 days from the end of 6 months of F.Y. to which it relates

LLP to file → Annual Return → In Form 11 → with RoC

↓

Public Document

Within 60 days of close of F.Y.

Appointment of Auditor → By designated partner

- First Auditor
  ↓
  Any time before the end of First F.Y.
- Subsequent Auditor
  ↓
  At least 30 days prior to end of each F.Y. (Other than First F.Y)
- Casual Vacancy
  ↓
  Caused by
  - Auditor
  - Firm

→ If designated partner fails → Other partners may appoint

Auditor's Duty Regarding Audit of LLP

- Engagement Letter
  ↓
  Writing
- Minutes Book
  ↓
  Refer
  ↓
  Resolutions
- LLP Agreement
  - Nature Of Business
  - Amount Of Capital
  - Interest
  - Drawings
  - PSR
- Reporting
  - Records
    - Correct
    - Reliable
  - Obtained
    - Info.
    - Explanation
  - Restriction?

Notes to Add

LLP is governed by Limited Liability Partnership Act, 2008. It is a form of business organisation which enshrines in itself the advantages of both the Company and Partnership forms of Organisation. 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) The Partners in an LLP and their rights and duties are governed by way of an agreement between them.

It defines a Small Limited Liability Partnership to denote any LLP:

(a) 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

(b) 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;

Whether LLP is required to maintain Books of Accounts:- An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. LLP's are required to maintain books of accounts which shall contain-

(1) 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,

(2) A record of the assets and liabilities of the LLP,

(3) Statements of costs of goods purchased, inventories, work-in-progress,

(4) Finished goods and costs of goods sold,

(5) Any other particulars which the partners may decide.

Audit of the Accounts of an LLP:- The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009. Such rules, inter-alia, 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 only in accordance with such rule.

Advantages / Purpose / Need of Audit

(1) Detection of Errors:- Auditing the accounts of a LLP helps in detecting errors & frauds & verification of financial statements.

(2) Disputes:- Disputes, if any between any partners in the matter of accounts can be settled with the help of audited accounts.

(3) Reliability:- Banks & financial institutions lend money to the firms only on the basis of audited accounts.

(4) Better Compliance and Management:- Periodical visits & suggestions by the auditor will be helpful in improving the management of the LLP.

(5) 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.

Returns to be maintained and filed by an LLP :-

- 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.

- Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months the financial year to which the Statement of Account and Solvency relates.

Appointment of Auditor: The auditor may be appointed by the designated partners of the LLP –

(1) At any time for the first financial year but before the end of first financial year,
(2) At least thirty days prior to the end of each financial year (other than the first financial year),
(3) To fill the casual vacancy in the office of auditor,
(4) 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 in 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.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

16. The accounts of every LLP shall be audited in accordance with rule 24 of LLP Rules 2009.

Ans. Incorrect: Rule 24 of LLP Rules 2009 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 only in accordance with such rules.

17. The auditor of an LLP may be appointed by the Designated Partners or other Partners whosoever is available at the time of appointment.

Ans. Incorrect: The auditor is to be appointed by the designated partners of the LLP. However , the Partners may appoint the auditors only if the Designated Partners have failed to appoint them.

Theory Question

18. Ban LLP is formed during the year 2021-22. They are not sure about the type of books of accounts to be maintained. What are the books of accounts that the LLP is required to maintain?

Ans. Books of Accounts Ban LLP is required to maintain: 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-

1. 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,
2. A record of the assets and liabilities of the LLP,
3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

Notes to Add

Notes to Add

AUDIT OF CHARITABLE INSTITUTION

(1) General
- Constitution → Study
- System of I.C.
- Trust Deed/ Regulation

(2) Subscription/ Donation
- Membership → Annual /Life
- Receipts
  - Control → Unused
  - Counter foils
  - List
    - Subscription
    - Donation

(3) Legacies → Corresponding
- Figures
- Info.

(4) Grants
- Amt. Recd. → Minute Book + Receipt
- Certificate

(5) Investment
- Counter foils
  - Dividend
  - Interest
- Calculation
- Dividend
  - Ex
  - Cum

(6) Rent
- Agreement
- Amount
- Due Date

(7) Income Tax Refunds

Notes to Add

In the case of audit of a charitable institution, attention should be paid to the following matters-

(1) General

(*i*) Studying the constitution under which the charitable institution has been set up.

(*ii*) Verifying whether the institution is being managed in the manner contemplated by the law under which it has been set up.

(*iii*) Examining the system of internal check, especially as regards accounting of amounts collected.

(*iv*) Verifying in detail the income and confirming that the amounts received have been deposited in the bank regularly and promptly.

(*v*) Examine the Trust Deed or the Regulations as laid down.

(2) Subscriptions and donations

(*i*) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.

(*ii*) 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.

(3) Legacies – Verifying the amounts received by reference to correspondence with any figures and other available information.

(4) Grants

(*i*) Vouching the amount received with the relevant correspondence, receipts and minute books.

(*ii*) Obtaining a certificate from a responsible official showing the amount of grants received.

(5) Investments Income

(*i*) Vouching the amounts received with the dividend and interest counterfoils.

(*ii*) Checking the calculations of interest received on securities bearing fixed rates of interest.

(*iii*) Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.

(*iv*) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

(6) Rent

(*i*) Examining the rent roll and inspecting tenancy agreements, noting in each case:

(*a*) the amounts of the rent, and

(*b*) the due dates.

(*ii*) Vouching the rent on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.

(7) **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.

(8) **Income Tax Refunds -** Where income-tax has been deducted at source 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:

(*i*) vouching the Income-tax refund with the correspondence with the Income- tax Department; and

(*ii*) checking the calculation of the repayment of claims.

(9) **Expenditure**

(*i*) 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.

QUESTIONS

Theory Questions

19. CA A is appointed as the auditor of a charitable institutions. Discuss the audit procedure undertaken by him while auditing the Subscription and Donation received by the charitable institution.

Ans. Audit Procedure in audit of Subscriptions & donations:

Audit Procedure to be undertaken by CA A in respect of Subscriptions and donations received by a Charitable Institution is:

(*i*) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.

(*ii*) 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.

Notes to Add

AUDIT OF EDUCATIONAL INSTITUTIONS (SCHOOL, COLLEGE OR UNIVERSITY)

(1) General
- School/College→Trust Deed/ Regulation
- University→Act/ Regulation
- MoM

(2) Fee
- Student Register
- Counter foils
- Advance Fee + Irrecoverable
- Studentship + Concession
- Fines + Dues
- Caution Deposit

(3) Grants/ Donation
- Rent rolls
- Endowment + Legacies
- Disallowed→Reason

(4) Expenditure
- P.F.
- Specific purpose donation
- Capital Expenditure→MoM
- Increases in salaries

(5) Assets & Liabilities
- Old arrears
- Caution Money
- System of Inspection
- Furniture + Stationery

(6) Compliances
- IT Refunds
- Funds
  - Poor Boys
  - Games
  - Hostel
  - Provident Fund

Notes to Add

The special steps involved in their audit are the following-

(A) General :-

(1) Examine the Trust Deed or Regulations, in the case of school or college andnote all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulation framed thereunder.

(2) 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.

(B) Fee from Students :-

(1) 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.

(2) 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.

(3) 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 off under the sanction of an appropriate authority.

(4) 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.

(5) 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.

(6) Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.

(7) Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

(C) Other Receipts/Grants & Donations :-

(1) Verify rental income from landed property with the rent rolls, etc.

(2) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(3) 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.

(D) Expenditure :-

(1) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(2) 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.

(3) Vouch, all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(4) 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.

(5) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(E) Assets & Liabilities :-

(1) Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.

(2) 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.

(3) 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.

(4) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(5) 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.

(F) Compliances :-

(1) 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.

(2) 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.

(3) 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.

Notes to Add

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Test Your Understanding

3. You are auditor of a school operating in your city. During audit of a year, it is noticed that fees concessions to students have been provided in substantial number of cases. Discuss, how, you as an auditor, would proceed to verify the same?

Ans. The fees concessions have to be under proper authority of school management. The auditor would verify internal controls in this regard. Besides, detailed checking of few cases needs to be undertaken to ensure genuineness of fees concessions and proper management approvals.

QUESTIONS

Theory Questions

20. Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered. Accountancy Course and which charges only Rs 500 per month from a student for his lodging/boarding.

Ans.

(*i*) Study the constitution under which the charitable institution has been set up whether under the Society Registration Act, as a trust or as a company limited by guarantee. Verify whether it is managed as contemplated by the law and rules and regulations made thereunder.

(*ii*) Examine the internal control structure particularly with reference to admission to hostel, expenses incurred on different kinds of activities.

(*iii*) Verify the broad nature of expenses likely to be incurred with reference to the previous year's annual audited accounts.

2. Verification of the receipts

(*i*) Check the amounts received on account of, monthly rentals, etc., and receipts issued for the same.

(*ii*) Ascertain that there is adequate internal control over the issue of official receipts, custody of unused receipt books, printing of receipt books, etc.

(*iii*) Cross - tally the rent received along with the number of students (from the student register) staying in the hostel during the year.

(*iv*) Check the amounts received from additional services rendered like guest fees, receipts for breakage, fines, penalties, etc.

3. Verification of expenses

(*i*) Check the day-to-day administration expenses incurred along with the necessary vouchers, supporting for the same like salary registers, repairs register, etc.

(*ii*) Verify whether the expenses incurred are in conformity with the budgets prepared internally or filed with the relevant authorities.

(*iii*) Check the amount spent on provisions of hostel facilities with reference to bills, etc.

(*iv*) See that whenever heavy expenditure has been incurred on renovation of the hostel, computer centre, etc. the same is accounted for properly (if such facilities are being provided by the hostel).

4. Verify investments made from surplus funds as well as existing investments by physically verifying the same and that they are in the name of the institution and that there is no charge/pledge against the same.
5. Verify all capital expenditure and expenditure on repairs, etc., incurred with the vouchers and also whether proper tenders, etc., were invited for the same. See that all furniture, glass, cutlery, kitchen utensils, liner, etc. are adequately depreciated.
6. Library Facilities: See that proper library register are maintained. The system regarding issue and receipt of books is in order. Late fee fines and money received on account of lost book is accounted for properly. Obsolete books are written off only after proper authorisation. Expenses incurred on newspapers and weekly magazines as compared to Journals and periodicals have been accounted for properly.
7. Check the provision of other additional facilities like computer facilities, etc. Ensure that proper registers are maintained for charging fees, based on monthly or hourly basis. In case such facility is extended to each room, whether the charges are payable on lump-sum basis or on actual usage basis. Also ensure that amounts spent have been allocated properly.
8. Verify whether the institution is eligible for income tax exemption and if not, whether provision for taxation has been made.

Notes to Add

Notes to Add

AUDIT OF HOSPITAL

(1) Register of Patients → Copies of Bills; → Attendance; → Amount Recoverable

(2) Collection of Cash → Entered→Cash Book; → Counter foils; → Rent

(3) Income → Investment Register; → Rents; → Dividends; → Interest

(4) Legacies + Donations

(5) Authorisation + Sanctions → Trustees; → Managing Committees

(6) Internal Check → Medicine + Linen + Apparatus + Instruments

(7) Depreciation

(8) Inventories

The special steps involved in such an audit are stated below-

Notes to Add

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 patients bills, 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 staff 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 insure 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 off 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.

QUESTIONS

Theory Questions

21. The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditures.

    You are required to mention special points of consideration while auditing such transactions of a hospital?

Ans. Special points of consideration while auditing certain transactions of a hospital are stated below-

(*i*) 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.

(*ii*) Collection of Cash: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(*iii*) Legacies and Donations: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(*iv*) 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).

(*v*) 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 staff have been duly authorised.

22. M/s T & Co. Chartered Accountants, a partnership firm, is appointed as an auditor of Treatment Hospital run by Smile Foundation, a charitable trust. Over and above the receipts of treatment of patients, during the year trust has received donations from various donors to treat COVID-19 patients and also incurred some capital expenditure for further development of the hospital. On some of the investment income, income tax has been deducted. What are the special points to be considered by M/s T & Co. while auditing such transactions of Treatment Hospital?

Ans. Audit of a Hospital:

(A) Receipts from treatment of patients

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 from patients: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patient's bills.

(B) Donations from donors to treat the patients: Ascertain those legacies and donation received for a specific purpose have been applied in the manner agreed upon.

(C) Capital Expenditure Incurred: Verify the Capital Expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee.

(D) 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:

(*i*) vouching the Income-tax refund with the correspondence with the Income-tax Department; and

(*ii*) checking the calculation of the repayment of claims/refund claim.

Notes to Add

Notes to Add

AUDIT OF CLUB

(1) Entrance Fee + Counter foils

(2) Subscriptions

(3) Arrears of Subscriptions

(4) Arithmetical Accuracy

(5) Irrecoverable Member Dues

(6) Price → Food, Drinks

(7) Purchase → Furniture + Sports items + Crockery

(8) Management Powers

Notes to Add

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 theyear.
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.

QUESTIONS

Theory Questions

23. State the points which merit consideration in the audit of a CLUB w.r.t its members.

Ans. The points which merit consideration in the audit of a CLUB w.r.t its members:-

1. Entrance Fee :- Vouch the receipt on account of entrance fees with– members' applications and counterfoils issued to them, on a reference to minutes of the Managing Committee.
2. Member 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. Subscription Arrears/in Advance :- Ensure that – arrears of subscriptions for the previous year have been correctly brought over, arrears for the year under audit and subscriptions received in advance have been correctly adjusted.

   Subscriptions received in advance should have been properly accounted for.
4. Arithmetical accuracy:- Check totals of various columns of the Register of members and tally them across.
5. Register of Members:- 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. 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.

Notes to Add

Notes to Add

AUDIT OF CINEMA

(1) Internal Control Mechanism
- **Entrance → Printed tickets**
- **Serially numbered + Bound into books**
- **Diff.**
  - **Show**
  - **Class**
- **Adv. Booking → Separate series**

(2) St. of ticket sold

(3) Free passes
(4) Tax Collected
(5) Advertisement
(6) Depreciation
(7) Adv. Paid to distributors
(8) Restaurant Income

The special steps involved in its audit are stated below-

Notes to Add

(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 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 different 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 foodstuffs, purchase of foodstuffs, cold drink, etc. as in the case of club.

QUESTIONS

Theory Questions

24. You are auditing the Books of accounts of Karla Multiplex which runs 15 Film shows everyday. One of the major issues which are of concern to you as an auditor is the Agreement entered into the Multiplex owners with the Film Distributors. State what points would you check as an auditor in this respect

Ans. Agreement with the Distributors :-

(*a*) Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.

(*b*) 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.

25. M/s PQ & Co., Chartered Accountants have been appointed as statutory auditor of CBD Multiplex Cinema Ltd. The audit team started the audit and verified the ledger and other books of accounts for the F.Y 2021-2022. However, one of the team members is of the view that the internal control mechanism of the company should also be verified.

Can you guide the audit team about the areas that will be covered in verifying the internal control mechanism?

Ans. Areas to be covered while verifying the Internal Control Mechanism in Multiplex: Audit Team of M/s PQ & Co. should cover the following areas to verify the internal control mechanism of CBD Multiplex Cinema Ltd.-

(*i*) that entrance to the cinema-hall during show is only through printed tickets;

(*ii*) that they are serially numbered and bound into books;

(*iii*) 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;

(*iv*) that for advance booking a separate series of tickets is issued; and

(*v*) that the inventory of tickets is kept in the custody of a responsible official.

26. Cinescreen Multiplex Ltd. is operating cinemas in different locations in Mumbai and has appointed you as an internal auditor. What are the areas that need to be verified in relation to receipts from sale of Tickets?

Ans. Audit of Cinema: The special steps involved in the audit of receipts from sale of tickets are stated below:

(*i*) Verify that entrance to the cinema-hall during show is only through printed tickets;

(*ii*) Verify that they are serially numbered and bound into books;

(*iii*) Verify 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;

(*iv*) Verify that for advance booking a separate series of tickets is issued;

(*v*) Verify that the inventory of tickets is kept in the custody of a responsible official.

(*vi*) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

(*vii*) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

(*viii*) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class.

(*ix*) 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 different shows held.

Notes to Add

AUDIT OF HIRE PURCHASE & LEASING COMPANIES

Hire Purchase:

Goods are let-out on Hire → Hirer has the option to purchase then

↓

In accordance with T & C of agreement

- Possession of Goods ↓ Transferred by owner ↓ On condition of Periodic Instalments
- Property in Goods to Pass ↓ On Payment of Last Instalment
- Hirer has the right ↓ To terminate the agreement ↓ Anytime before the property passes

→ Audit Procedure

(1) Agreement in Writing + Signed by all parties

↓

(2) Specifies

- **HP Price**
- **Cash price of Goods**
- **Date of Agreement**
- **Instalments**
  - **Number**
  - **Amount**
  - **Date of Payment**
  - **Where Payable**
- **Identification of Goods**

(3) Ensure → Instalments are regularly received

Leasing:

Lesser acquires the right to use assets → for an agreed period

↓

In consideration of payment of rent

- **Finance Lease** ↓ **Like loan Agreement**
- **Operating Lease** ↓ **Like Rent Agreement**

→ Finance Lease Modalities

(i) Lessee → select equipment — Functional fitness + Specifications — Lessor ↔ No Participation

Approach Lessor
- Directly
- Broking Agency

(ii) Lease Agreement
- Negotiated
- Rates Finalised

(iii) Manufacturer → Delivers equipment → Lessee
↓
Notice of Acceptance

(iv) Lease Agreement → Detailed terms

(v) Lease Tenure → Lessee
- → Pay Rentals Regularly
- → Keep equipment
  - Repaired
  - Working
- → Entitled to
  - Manufacturer's warranty
  - After Sales Service

(vi) End of Lease pd. → Equipment Returned
- → Renewal Right
- → Purchase Option
  ↑
  Not in Original lease Agreement

→Audit Procedure

(1) Check object clause → of leasing Co. → Ensure that they can take a financial activity

(2) Procedure →for credit analysis of the lessee

(3) Lease Agreement includes

- **Description of**
  - **Lessor**
  - **Lessee**
  - **Equipment**
  - **Location** — **Where it is to be installed**
- **Equipment to be returned on termination?**
- **Amount of**
  - **Leave Tenure**
  - **Date of Payment**
  - **Late charges**
  - **Deposits**
- **Subletting by Lessee allowed?**

(4) Examine → Lease Proposal form
(5) Ensure → Invoices of Equipment are retained safely
(6) Examine → Acceptance letter of lessee
(7) Any Board Resolution regarding lease
(8) Copies of Insurance Policy

	Operating Lease	Financial Lease
Ownership	Remains with the lessor	Transfer option
Accounting Treatment	Renting arrangement. Treated as operating expenses	Loan arrangement. Appears on the balance sheet of the lessee
Purchase Option	Lessee does not have any option	Lessee to have a purchase option
Lease Term	Generally < 75 % → useful life	Generally ≥ estimated economic life

(A) HIRE - PURCHASE:

(1) A 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-

(*i*) possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments,

(*ii*) the property in the goods is to pass to such person on the payment of the last of such instalments, and

(*iii*) such person has a right to terminate the agreement at any time before the property so passes.

(2) 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:

(*i*) Hire purchase agreement is in writing and is signed by all parties.

(*ii*) Hire purchase agreement specifies clearly-

(a) The hire-purchase price of the goods to which the agreement relates;

(b) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;

(c) The date on which the agreement shall be deemed to have commenced;

(d) 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

(e) The goods to which the agreement relates, in a manner sufficient to identify them.

(*iii*) Ensure that instalment payments are being received regularly as per the agreement.

(B) LEASES :-

(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. In other words, the lease is, in effect, 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.

(3) **A normal finance lease transaction usually goes through the following modality:**

(*i*) The lessee will select the equipment, and satisfy himself about its functional fitness and specifications, the lessor has no participation at this stage.

(*ii*) Having chosen the equipment, the lessee approaches a lessor, either directly or through a lease-broking agency.

(*iii*) The lease agreement is broadly negotiated and the rates are finalised. The lessor places an order on the manufacturer as chosen by the lessee.

(*iv*) The manufacturer delivers the equipment at the site of the lessee, and the latter gives notice of acceptance to the lessor.

(*v*) 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.

(*vi*) During the lease period, the lessee:

- Will pay rentals regularly at periods agreed-upon, which are usually each calendar month;
- Will keep the equipment in good repair and working condition, etc.
- Will be entitled to any manufacturer's warranties or after-sales services.

(*vii*) 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.

(4) **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:

(*i*) 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).

(*ii*) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.

(*iii*) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.

(*iv*) 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.

Students need to pay attention that AS-19 define that lease arrangements could be of 2 types i.e. 1 Finance Lease and 2 Operating Lease.

Finance Lease: An arrangement with the following attributes qualifies as a Finance Lease:

- The lease arrangement transfers ownership of the asset to the lessee at the end of the lease term;
- 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;
- The lease term is for the major part of the economic life of the asset even if title is not transferred;
- 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
- 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 differences under both the above said types of lease arrangements:

	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.

Notes to Add

AUDIT OF HOTELS

(1) Internal Control
- → Pilfering → Greatest Problem
- → K.O.T.
- → Taxes
  - → Collected
  - → Paid

(2) Room sales + Hall Booking

(3) Inventories

(4) Fixed Assets

(5) Casual Labours

(6) Shops

Notes to Add

The special considerations in a hotel audit can be summarised as follows:

(1) **Internal Controls-** Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimise the leakage as far as possible. 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. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

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 inorder.

The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. 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. 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.

(2) **Room Sales & Hall Bookings -** 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. 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. 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.

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. 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. The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.

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 tariff.

(3) **Inventories -** The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. 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. The auditor should carry out tests to ensure that all such documentation is accurately processed.

Areas where large quantities of inventory are held should be kept locked, the key being retained by the departmental manager. 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. 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. 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.

(4) Fixed Assets - 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. This can lead to confusion between each inventory items and similar assets which are accounted for on a more normal form on assets basis. 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. The auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, where as costs of major alterations and additions to the hotel building and facilities capitalised.

(5) Casual Labour - The hotel trade operates to very large extent on casual labour. The records maintained of such wage payments are frequently inadequate. The auditor should ensure that defalcation on this account does not take place by suggesting proper controls to the management.

(6) Travel Agents & Shops -

(*i*) 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 are recovered from the travel agents or booking agencies as per the terms of credit allowed.

(*ii*) Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

Notes to Add

Notes to Add

QUESTIONS

Theory Questions

State with reasons (in short) whether the following statements are correct or incorrect:

27. An auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts in the case of audit of a Hotel.

Ans. Incorrect: The auditor should ensure that proper valuation of occupancy-in- progress at the balance sheet date is made and included in the accounts for proper recording of closing and opening entries and maintenance of accounts on Accrual basis as per the Matching concept.

28. As an auditor, what would be your areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel.

Ans. Following points merit consideration while auditing the element of ROOM SALES during the audit of a Hotel :-

(*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 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. 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.

(*e*) Ensure compliance with the provisions of FEMA and RBI if receipts are in foreign currency. Ensure application of proper Conversion rate.

(*f*) Special emphasis to be laid on receipts through Credit Cards.

(*g*) The auditor should ensure that proper valuation of occupancy-in- progress at the balance sheet date is made and included in the accounts.

29. Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined explain.

Ans. Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined.

It is the responsibility of management to introduce controls which will minimise the leakage as far as possible.

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. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

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.

The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. 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. 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.

30. You have been appointed as an auditor of ABC Hotel, a three star hotel, for Financial Year 2021-22. As an auditor what are the special points that need to be considered in verifying the Inventories in the nature of food and beverages?

Ans. Verification of inventories in the nature of food and beverages: The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. 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. The auditor should carry out tests to ensure that all such documentation is accurately processed. Therefore, following points may be noted in this regard:

(*a*) All movement and transfer of inventories must be properly documented.

(*b*) Areas where inventories are kept must be kept locked and the key retained by the departmental manager.

(*c*) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.

(*d*) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.

(*e*) The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the year-end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories.

Notes to Add

AUDIT OF CO-OPERATIVE SOCIETIES

Co operative
Co-operative
Co-op
Coop

Autonomous AOP→untitled voluntarily
↓
To meet common

Economic | Social | Cultural

Needs
+
Aspirations
↓
Through Jointly owned Enterprise

Audit of Cooperative Societies
↓
Business organisations
↓
Special mode of doing business
↓
By co-operation

- By pooling together all means of production
- Elimination of middlemen
- Elimination from Exploitation from outside sources

→Acts applicable to societies

- **The Co-operative Societies Act, 1912→ Central Act→ Applicable to many states**
  - **With**
  - **Without**
  - **Amendments**
- **Specific state Acts → Maharashtra West Bengal, Odisha**
- **The Multi - State Cooperative Societies Act, 2002→Societies not confined to one state**

→A CA Can

- **Guide in A/c. writing**
- **Installation of A/c. System**
- **Internal Audit**
- **Management Services**
- **Taxation etc.**

BACKGROUND

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". 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.

Co-operative society is a business organisation 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.

A chartered accountant has to play a significant role in the development of co-operative organisations on scientific lines. In this Unit, it is proposed to give a few guidelines in the matter of audits of co-operative societies.

Apart from audit, some other professional services could be rendered by chartered accountants such as-

(1) guidance in accounts writing,
(2) installation of accounting system,
(3) internal audit,
(4) management accounting services,
(5) taxation etc.

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.

Notes to Add

AUDIT AS PER SECTION 17 OF THE CO-OPERATIVE SOCIETIES ACT, 1912

(1) Registrar Shall — Audit / Authorize — A/c's of society → Once at least every year

Authorize ↓ Some other person to audit

Some other person to audit — General / Special — Order ↓ In writing

(2) Audit Includes
- Examination → of overdue debts
- Verification → of Assets & Liabilities

(3) Auditor shall have access → at all times → to
- Books of A/c.
- Papers
- Securities of Society
- Every officer shall furnish info.

Points to be kept in mind for appointing Auditor

(1) Qualification of Auditor → A CA or Some state acts allow persons having
- Govt. Diploma in Co-operative Accounting
- Govt. Diploma in Co-operation & Accountancy

Served as an Auditor in Co-operative Dept. of Govt.

(2) Appointment of Auditor → By Registrar of Co-operative Societies

↓

Audit Report to be submitted to him

→ Audit fee → paid by society

↓

Prescribed by Registrar

(3) Books, A/c's & Other Records → of Co-operative Society (Sec. 43(h) of Central Act)

Generally →

(*i*) Daily cash sales summary Register

(*ii*) Register for collection from Debtor

(*iii*) Register for Recovery of Loans

(*iv*) Register for Loan Disbursements

(*v*) Any other Columnar Register

(4) Restriction on share Holdings (Sec. 5)

on each member to be ≤ 20% of paid up share capital or ≤ ₹ 1000/-

↓

Prov . Of By-Laws → Not Contradictory

Limits in State acts may be different

(5) Restrictions on Loans (Sec.29)

- Only to members are allowed
- Can be given to another society ↓ With special sanction of Registrar

(6) Restriction on Borrowings (Sec.30)

Allowed up to limits mentioned in By-laws of society

(7) Investment of funds (Sec.32)

Allowed in

- Central or state Cooperative Bank Or Co-operative or other banks approved by Registrar
- Securities specified in Sec. 20 of the Indian Trust Act, 1882
- Securities of Other Societies ↓ With Limited Liability
- Permitted by
  - CG
  - SG

(8) Appropriation of profits (Sec.33) → % age of profits should be transferred to → Reserve Fund → Before Distribution as

- Dividend
- Bonus

To members

(9) Contribution to charitable Purpose (Sec.34)

Registered Societies May transfer → ≤ 10% of NP
- With sanction of Registrar
- For any charitable purpose

↓

After transfer to Reserve fund

(10) Reserve fund
- Investment Outside business
- Promote Object of Society
- Utilization as W.C.

→ Only if state Act provides

(11) Contribution to Education fund → only if state Act Provides

(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.

The following points should be kept in mind in connection with the audit of a co-operative society:

(1) 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.

(2) 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.

(3) Books, Accounts and other records of Co-operative Societies- 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:

(*i*) All sums of money received and expended by the society and the matters in respect of which receipts and expenditure take place.

(*ii*) All sales and purchases of goods by the society.

(*iii*) Assets and liabilities of the society.

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. 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.

Depending upon the nature and object of the society, different 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, different 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.

4. **Restrictions on share holdings -** 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/-. The auditor of a co-operative society will be concerned with this provision so as to watch any breach relating to holding of shares. One should also watch whether any provision in the bye-laws of the society is not contrary to this statutory position. The State Acts may provide limits as to the shareholding, other than that provided in the Central Act.

5. **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 the loaning powers of the society to its members or to other societies in the interest of the society concerned and its members.

6. **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.

7. **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.

8. **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.

9. **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.

10. **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.

11. **Contribution to Education Fund -** Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State Federal Society, at the appropriate rate as per the class of the society. Contribution to Education Fund is a charge on profits and not an appropriation.

Apart from statutory provisions relating to Reserve Fund, the auditor may have regard to the provisions in bye-laws and Rules and Regulations of the society regarding the appropriation of profits. 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. 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.

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. The auditor should point out such spots where statutory provisions of any law are in contradiction with the generally accepted accounting principles.

Notes to Add

Notes to Add

SPECIAL FEATURES OF CO-OPERATIVE AUDIT

→ Special features for conducting an audit : (10 points)

(1) Examination of overdue debts
- 6 months to 5 years
- > 5 years
- Affecting working capital
- Proper
  - Provision
  - Classification

(2) Overdue Interest → Interest
- accrued
- accruing

On A/c's → where even principal amount is overdue

- Should not be included in calculation of Interest O/s
- In practice, Overdue Interest Reserve A/c. is created → Any credit of overdue Interest → credited to Interest A/c. → is Reduced

(3) Certification of Bad Debts by → Managing Committee → Auditor

(4) Valuation of Assets & Liabilities

(5) Adherence to Co-operative principles → Objectives have been achieved?

(6) Observation of the provisions of → Laws → Regulations

(7) Verification of Members register + Examining their Pass Books

↓

Regarding Loans Given

(8) Special Report to Registrar → In case of irregularities
- Personal Profiteering
- Fraud Mismanagement
- Disproportionate advance to vested Interest Groups

(9) Audit classification of society → Auditor awards a class to society

↓

After Judgement → Based on criteria specified by Registrar

If management is not satisfied by classification

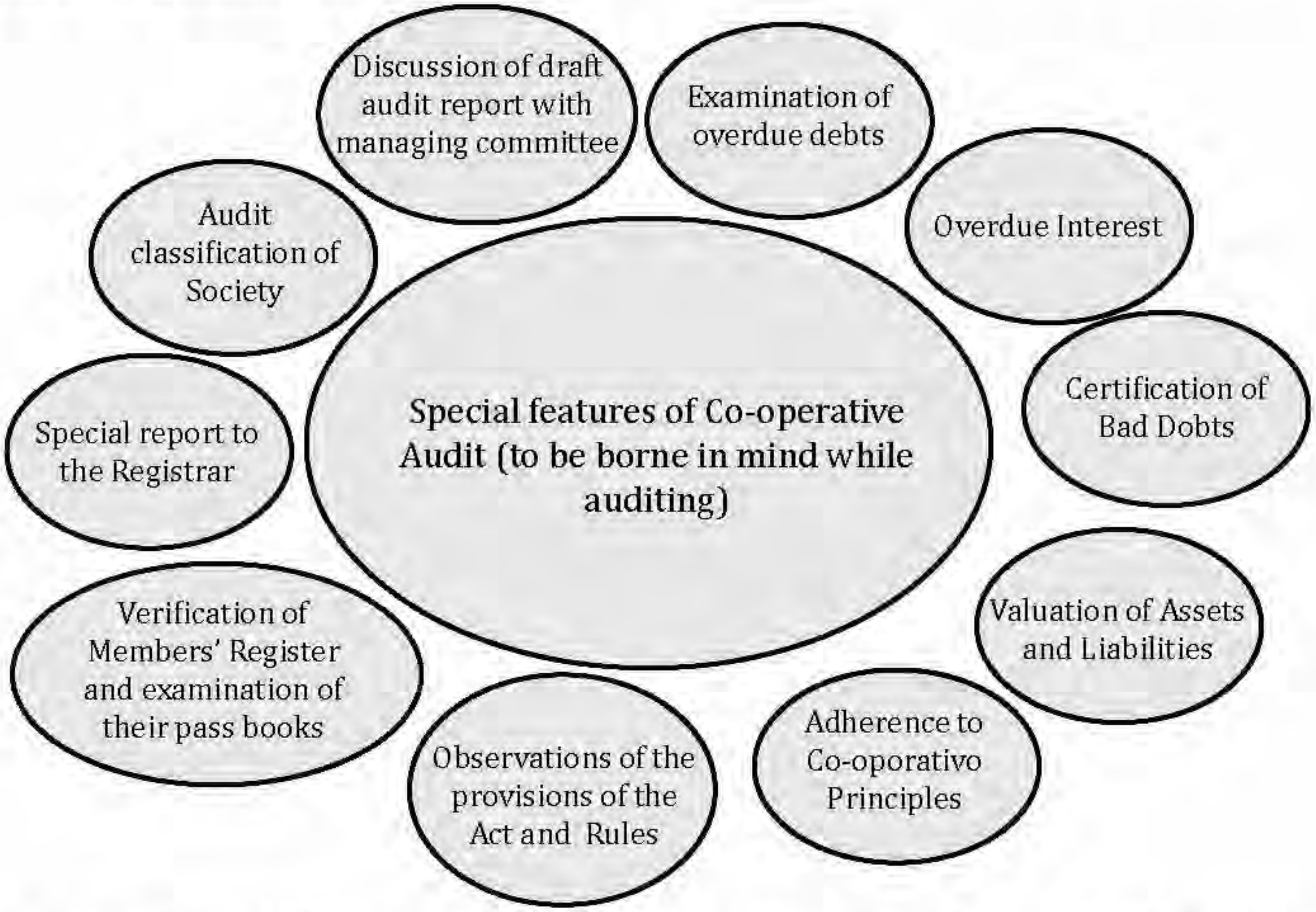
↓

It can appeal to Registrar → may direct review of Audit classification

(10) Discussion of Draft Audit Report → with Managing Committee

Notes to Add

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. It need not be discussed in detail.



However, the special features of co-operative audit, to be borne in mind in general while conducting the audit are as follows:

1. **Examination of overdue debts -** 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. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. 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. The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory.
2. **Overdue Interest -** Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.
3. **Certification of Bad Debts -** 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 off only when they are certified as bad by the auditor. Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. Where no such requirement exists, the managing committee of the society must authorise the write-off.

4. **Valuation of Assets and Liabilities -** 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. The auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost less adequate provision for depreciation. 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. The current assets be valued at cost or market price, whichever is lower. 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.
5. **Adherence to Co-operative Principles -** 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. The assessment is not necessarily in terms of profits, but in terms of extending of benefits to members who have formed the society. Considered from the viewpoint of social benefits it may be looked into that how far the sales could be affected at lower prices. For the achievement of these activities, cost accounting methods, store control methods, techniques of standard costing, budgetary control etc. should be adopted. 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. While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds.

   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 thepurpose.
6. **Observations of the Provisions of the Act and Rules -** An auditor of a co- operative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws. The financial implications of such infringements should be properly assessed by the auditor and they should be reported. Some of the State Acts contain restrictions on payment of dividends, which should be noted by the auditor.
7. **Verification of Members' Register and examination of their pass books -** Examination of entries in members pass books regarding the loan given and its repayments, and confirmation of loan balances in person is very much important in a co-operative organisation to assure that the entries in the books of accounts are free from manipulation.

   Specifically in the rural and agricultural credit societies, members are not literate and as such this is a good safeguard on their part. Of course this checking will be resorted to on a test basis, which is a matter of judgement of the auditor.
8. **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:

   (*i*) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of thesociety.

   (*ii*) Detection of fraud relating to expenses, purchases, property and stores of the society.

(*iii*) Specific examples of mis-management. Decisions of management against co- operative principles.

(*iv*) 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.

9. **Audit classification of society -** After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. 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. The auditor should be very careful, while making a decision about the class of society.

10. **Discussion of draft audit report with managing committee -** 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. The audit report should never be finalised without discussion with the managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

Notes to Add

AUDIT, INQUIRY AND INSPECTION OF MULTI-STATE CO-OPERATIVE SOCIETIES

Audit, Inquiry & Inspection of Multi State Cooperative Society

Funds of MSCoS → Cannot be utilized (MSCoS)

↓

for any Political Purpose

→ Books of A/c.

(1) All sum of Money — Received / Expended

(2) Sale / Purchase — of goods

(3) Assets + Liabilities

(4) If engaged in — Production / Processing / Manufacturing — Particulars of material & Labour

Books of Accounts– Multi State Cooperative Society

- All sums of money received and expended
- All sales and purchase of goods
- Assets and Liabilities
- If engaged in production, processing and manufacturing, then books relating to utilization of materials or labour or other relevant items

Notes to Add

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. The Act contains detailed provisions regarding registration, membership and management of such societies. The funds of a Multi-State co-operative society cannot be utilised for any political purpose. The Act contains detailed provisions regarding the investment of funds and restrictions on loans, borrowings, etc.

Notes to Add

....

....

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 matters in respect of which the receipt and expenditure take place;

(*b*) all sale and purchase of goods;

(*c*) the assets and liabilities;

(*d*) in the case of a Multi-State Co-operative society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-hours of such a society.

Notes to Add

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Diagram showing the Books of Accounts to be maintained by Multi State Co-operative Society

Audit of MSCOS (Sec.72 of the MSCOS Act, 2002)

(1) Qualification of Auditor → Only a practicing CA can be appointed

(2) Disqualification of Auditor →

- (i) A body Corporate
- (ii) Officer / Employee of MSCOS
- (iii) Person who is
  - – a member
  - – in employment of officer / employee of MSCOS
  - – Indebted to MSCOS
  - – given guarantee
  - – Provided security

  of a 3rd party to MSCOS > ₹1,000/-

(3) Vacation of office → If auditor attracts Disqualifications

↓

After appointment

↓

Deemed to have vacated his office

(4) Appointment of Auditor (Sec.70)

First Auditor

↓

Within 1 month of → D.O.R.

↓

If fails to appoint

↓

Appointed @ G.M.

↓

Should hold office till the conclusion of I AGM

Subsequent Auditor

↓

Appointed @ each A.G.M.

↓

From conclusion of that AGM till the conclusion of Next AGM

(5) Powers of Auditor (Sec. 73)

Right to access

- Books
- Vouchers

Kept anywhere

Obtain such info. He may consider necessary

(6) Duties of Auditor (Sec.73(2)

- **Loans & Advances**
  - **Properly Secured**
  - **T & C not prejudicial to the interest of MSCOS**
- **Transactions not merely book entries + not prejudicial to interest of MSCOS**
- **Personal Expenses charged to Revenue**
- **Shares allotted for Cash?** ↓ **Cash Received?** ↓ **If not, same stated in Books?**

(7) Content of Audit Report (Sec. 73(3) & 73(4)

Like General Audit Report (Chapter 8)

(8) Powers of CG to direct special Audit (Sec. 77)

- **Affairs not managed in accordance with prudent Commercial practices**
- **Managed as it would cause injury to interest of Trade / Industry / Business**
- **Financial Position would endavger its solvency**

→ **Special Audit only if** [**CG** / **SG** / **Both**] — **Holds > 51% paid up share capital in MSCOS**

→ Expenses → of special audit
- Determined by CG
- To be paid by MSCOS

↓

Report to CG

↓

If CG → Does not take any action → Within 4 months

↓

send [copy / extract / comment] to
- Circulate to members
- Read in GM

(9) Inquiry by Central Registrar (Sec.78)

\+

Inspection of MSCOS (Sec. 79)

Central Registrar → Communicate

↓

Within 3 months

↓

on receipt of Report

↓

On request by

- Federal cooperative
  ↓
  To which MSCOS is affiliated
- Creditor
- $\geq \frac{1}{3}$ members of Board
- $\geq \frac{1}{5}$ members of MSCOS

→ 15 days notice must be given to MSCOS

↓

Within 3 months of date of date of receipt of Report

↓

Communicate to MSCOS

Notes to Add

1. **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 officer 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 office as such.

2. **Appointment of Auditors -** 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. 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.

   The subsequent auditor or auditors are appointed by Multi-State co-operative society, at each annual general meeting. The auditor or auditors so appointed shall hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

3. **Power and duties of Auditors –** Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. 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.

   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.

4. **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.
      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.
5. **Power of Central Government to direct special audit in certain cases -** 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.

Notes to Add

Notes to Add

- Power of Central Government to Direct Special Audit
  - Affairs Not Managed in Accordance With Prudent Commercial Practices
  - Managed as it would Cause Injury to Interest of Trade or Industry or Business
  - Financial Position is such as would endanger its Insolvency

Notes to Add

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:-** 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.

   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. 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:-** 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. 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.

Notes to Add

INQUIRY BY CENTRAL REGISTRAR UNDER SECTION 78

1. **When:-** The Central Registrar may, on a request from:-
   - a federal co-operative to which a Multi- State Co-operative society is
   - affiliated or
   - a creditor or not less than one-third of the members of the board or
   - not less than one-fifth of the total number of members of a Multi-state co-operative society,
2. **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.
3. **Opportunity of being Heard:-** However, before holding such inquiry fifteen days notice must be given to the Multi-State co-operative society.
4. **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 head quarters of the society to consider such matters as may be directed to him, and where the officers 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.
5. **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 MULTI-STATE CO-OPERATIVE SOCIETIES UNDER SECTION 79

1. **When:-** The Central Registrar may, on a request from
   - federal co-operative to which a Multi- State Co-operative society is
   - affiliated or a creditor or
   - not less than one-third of the members of the board or
   - not less than one-fifth of the total number of members of a Multi-State co-operative society
2. **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.
3. **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.

4. **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.
5. **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.

Test Your Understanding

4. A society has been formed by pan India employees of a public sector bank. The purpose of society is to promote savings habits of members and to grant loan to them up to a small specified amount. Small savings are promoted amongst members by way of compulsory contribution from monthly salary. Identify type of society and also discuss nature of books of accounts to be maintained by such a society.

Ans. The society is in nature of Multi-state cooperative society as it serves interests of members in more than one state. It accepts small savings from its members and grants loan to members. 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 matters in respect of which the receipt and expenditure take place
(*b*) the assets and liabilities

QUESTIONS

Theory Questions

31. Central Govt. hold 55% of the paid up share Capital in Kisan Credit Co- operative Society, which is incurring huge losses. Advise when the Central Government can direct Special Audit under Section 77 of the Multi State Co- operative Society Act.

Ans. 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. Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:
(*i*) 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

(*ii*) 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

(*iii*) that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

Thus, in the given case since Central Govt is holding 55% shares and financial position of Kisan Credit co- operative society is in danger, Central government can direct for special audit.

32. No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. Explain stating clearly when and how such inspection can be made. Also state the powers available with the Central Registrar in this regard along with provisions relating to communication of the inspection report under the said section.

Ans. Inspection of Multi-State Co-operative societies under Section 79

(1) When: The Central Registrar may, on a request from

(*i*) federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or

(*ii*) not less than one-third of the members of the board or

(*iii*) not less than one-fifth of the total number of members of a Multi-State co-operative society

(2) 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.

(3) 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.

(4) 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.

(5) **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.

Notes to Add

Notes to Add

AUDIT OF TRUST & SOCIETIES

Charitable entities → Legal Form

- Trust
- Society
- Sec. 8 Co.

Governed By

- Trust: Public Trust Act → states; The Indian Trust Act, 1882 ↓ State Act not exist
- Society: The Society Registration Act, 1860
- Sec. 8 Co.: The Companies Act, 2013

+

The Income Tax Act, 1961

+

The Foreign Contribution (Regulation) Act, 2010

❖ Books of A/cs →

i. Cash Book
ii. Ledger
iii. Journal
iv. Copies of Bills
v. Original Bills

❖ F.S. — B/s, I/E — Format → State laws

❖ Auditor's Responsibility →

i. Obtain — Books, Records
ii. Company — AS, SA
iii. Test check
iv. Keep Audit working papers

- Work done + By whom
- Explanation + Info
- Decisions taken
- Judicial pronouncement relied upon
- Certificates — Client, Mgt.

❖ Working Papers → Provide A.E.

- Opinion ↓ Based on examination
- Due cognizance — Info., Explanation
- Info., Explanation — Full + Complete
- Subjected — Info., Explanation — Reasonable Test

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.

- 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.
- If the charitable institution is formed as a Society, it will be governed by the Societies Registration Act, 1860.
- The charitable institution can also be formed as a non-profit company under section 8 of the Companies Act, 2013.
- Apart from the above legislations, the Income Tax Act 1961 will be applicable to charitable institutions.
- 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; journal;
(iii) 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;
(iv) original bills wherever issued to the person and receipts in respect of payments made by the person;
(v) 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 effected;

FINANCIAL STATEMENTS:- Every year the trust has to prepare financial statements like the Balance sheet and Income and expenditure statements based on its books of accounts. The format for preparation and presentation of financial statements is prescribed under respective state laws. 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

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. 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.

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. He will have to conduct the audit by applying the generally accepted auditing procedures, which are applicable for any other audit. He can apply the test checks depending on the evaluation of internal control procedures followed by the assessee. The auditor will also have to keep in mind the concept of materiality depending upon the circumstances of each case.

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:

(i) the opinion expressed by the auditor is based on the examination made by him;

(ii) 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;

(iii) 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

(iv) 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

Notes to Add

Notes to Add

TRUST

❖ TRUSTS → Auditor to ascertain

- A/c ↓ Regularly Maintained
- Receipt + Disbursement ↓ Properly + Correctly ↓ Shown
- Cash
  - Bal.
  - Vouchers
  - Custody
    - Manager
    - Trustee
- Amount
  - O/S > 1 Year
  - w/off
- Max. + Min. ↓ No. of Trustee
- Meetings ↓ Regular
- Trustee
  - Debtor
  - creditor
  - Of Trust

Notes to Add

The auditor has to ascertain

(a) whether accounts are maintained regularly and in accordance with the provisions of the applicable Act and the rules;

(b) 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.

(c) 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;

(d) whether all books, deeds, accounts, vouchers or other documents or records required by the auditor were produced before him;

(e) 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.

(f) 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;

(g) whether any property or funds of the Trust were applied for any object or purpose other than the object or purpose of the Trust;

(h) the amounts of outstanding for more than one year and the amounts written off, if any;

(i) 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.

(j) 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.

(k) whether the maximum and minimum number of the trustees is maintained;

(l) whether the meeting are held regularly as provided in such instrument.

(m) whether the minute books of the proceedings of the meeting is maintained.

(n) whether any of the trustees has any interest in the investment of the trust.

(o) whether any of the trustees is a debtor or creditor of the trust.

(p) 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.

(q) 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 –

(r) any special matter which the auditor may think fit or necessary to bring to the notice of the Deputy or Assistant Charity Commissioner.

Notes to Add

SOCIETIES

❖ SOCIETIES → Auditor's Consideration

- Governing Legislation
- Object of Soc.
- Registration under
  - The foreign contribution (Regulation) Act, 2010
  - The Income Tax Act, 1961
- Understanding ↓ I.C.
- Appro. A/c Policies
- Inquiries ↓ Registrar

Notes to Add

The auditor's considerations:-

(a) 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.

(b) Object of society needs to be ascertained from its memorandum of association/bye laws. Its activities may include charitable, social, cultural or educational activities.

(c) Ascertain whether society has obtained registration under Foreign Contribution (Regulation) Act, 2010 in case foreign contributions are received.

(d) Ascertain whether it is also registered under relevant provisions of Income Tax Act which may make it eligible for tax exemption on its income.

(e) 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.

(f) Evaluate appropriateness of accounting policies with special reference to donations and grants. Also evaluate accounting policies in relation to specific grants.

(g) In case some expenses incurred by society are reimbursed by donors, ascertain how these are recognized in financial statements.

(h) 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.

(i) 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.

(j) 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.

CASE STUDY

Consider the following five descriptions: -

(A) Audit of "Implementation of Nagpur Metro Rail Project" was conducted by the Comptroller and Auditor General of India.

Following is extract of few audit findings placed on website cag.gov.in.

"The location of New Airport station was not ideal from the viewpoint of ridership due to sparse population in and around the station and also from the accessibility point of view.

Notes to Add

Cotton Market station, the second additional station was projected to have high peak hour peak direction trips but the work was kept on hold midway citing fund crunch due to non-release of pending contribution from stakeholders. However, the situation could have been managed through prioritization of works."

(B) Another set of audit findings in respect of audit of Haryana Power Generation Corporation Limited, a wholly owned government company responsible for operation of power generation plants in state of Haryana is as under: -

"The main reason for low generation was higher variable cost of thermal power stations which resulted in backing down of plants."

(C) A report was tabled in Parliament highlighting main features of direct taxes administration of country as mandated in Constitution of India. This report primarily discussed compliance to the provisions of the Income Tax Act, 1961 and the associated rules and procedures etc. as applied to administration of direct taxes including irregularities noticed in finalizing assessments etc.

(D) Radial finance corporation Limited is a government company. The audit of the company is conducted by statutory auditors appointed by Comptroller and Auditor General of India.

(E) Bharat Insurance Company Limited is a general insurance government owned company. The statutory auditor is appointed by Comptroller and Auditor General of India.

The annual report for a particular year also contains comments of statutory auditors on matters such as whether company has carried out reconciliations in respect of its inter-company balances with other government owned insurance companies.

QUESTIONS

Theory Questions

Based on above, answer following questions:

33. Based upon plain reading of audit findings stated at Para (A), identify type of audit carried out by office of the Comptroller and Auditor General of India.

(*a*) Audit against provision of funds (*b*) Propriety audit
(*c*) Performance audit (*d*) Compliance audit

Ans. (*c*)

34. Keeping in view audit findings in respect of Haryana Power Generation Corporation Limited, identify type of audit carried out.

(*a*) Audit of Government Company (*b*) Audit against rules and orders
(*c*) Compliance audit (*d*) Performance audit

Ans. (*d*)

35. Which of the following is the most appropriate statement in context of report tabled in Parliament regarding administration of direct taxes?

(*a*) It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Comptroller and Auditor General of India.

(*b*) It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by an independent task force of experts.

(*c*) It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Central Board of Direct Taxes.

(*d*) It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by Central Board of Direct Taxes.

Ans. (*a*)

36. Who is empowered to conduct "supplementary audit" in case of Radial finance Corporation Limited, a government company?

(*a*) Central Government

(*b*) Another independent auditor appointed by CAG

(*c*) CAG

(*d*) Another independent auditor appointed by Ministry of Corporate Affairs

Ans. (*c*)

37. As regards comments of auditors specified in respect of audit report of above insurance company, which of the following is likely to be most appropriate statement?

(*a*) Such are likely to be comments of test audit carried out by CAG.

(*b*) Such are likely to be comments in respect of directions to statutory auditor by CAG for reporting on specific aspect of their audit work.

(*c*) Such are likely to be comments of supplementary audit carried out by CAG

(*d*) Such are likely to be comments of statutory auditors in accordance with requirements of Standards on Auditing

Ans. (*b*)

Multiple Choice Questions (MCQ)

1. The audit of municipal corporation of a large metro city is in progress. Which of the following is not likely an objective of such as audit?

   (*a*) To report on the adherence to legal and administrative requirements
   (*b*) To report on whether value is being fully received for money spent
   (*c*) To report on the weakness of systems of financial control
   (*d*) To provide better civic amenities to residents of metro city

Ans. (*d*)

2. "Save Democracy" is an NGO working in cause of promoting democracy and democratic institutions in many countries including India. Its Indian counterpart has received funds from a renowned "Flower Trust" of US. As auditor of NGO, which of the following laws/orders would be relevant to you in context of above information?

   (*a*) Income Tax Act, 1961
   (*b*) Foreign Contribution Regulation Act, 2010
   (*c*) Companies Act, 2013
   (*d*) Orders issued by Ministry of Social Justice and Empowerment

Ans. (*b*)

3. The appointment of first auditor of a multi-state cooperative society is made by: -

   (*a*) Central Registrar (*b*) Board of society
   (*c*) Members of society (*d*) Central Government

Ans. (*b*)

4. Consider following revenue sources of Union Government.

   (P) Revenues from direct taxes
   (Q) Revenues from Goods and Services Tax
   (R) Revenues from Custom Duties
   (S) Revenues from Excise Duties

   Out of P, Q, R and S, which of the following flow to "Consolidated Fund of India"?

   (*a*) P, Q and R (*b*) P, Q and S
   (*c*) P and Q (*d*) P, Q, R and S

Ans. (*b*)

5. An LLP files compliance returns with: -

   (*a*) Registrar of firms & societies (*b*) Central Registrar
   (*c*) Registrar of Companies (*d*) Local fund audit wing

Ans. (*c*)

❑❑❑

CHAPTER

10 Audit of Banks

S. No.	Sub Topics	Easy	Moderate	Hard
01.	Introduction			
02.	Understanding of Accounting System in Banks			
03.	Bank Audit Approach			
04.	Income Recognition Policy			
05.	Form and Content of Financial Statements			
06.	Audit of Accounts			
07.	Eligibility, Qualifications and Disqualifications of Auditor			
08.	Appointment of Auditor			
09.	Remuneration of Auditor			
10.	Powers of Auditor			
11.	Auditor's Report			
12.	Format of Report			
13.	Long Form Audit Report			
14.	Reporting to RBI			
15.	Conducting an Audit			
16.	Advances			
17.	What do Advances Comprise			
18.	Legal Requirements of Disclosure in the Balance Sheet			
19.	Classification of Advances			
20.	Security Wise			
21.	Mode of Creation of Security			
22.	Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances			
23.	Accounts where there is Erosion in the Value of Security / Frauds Committed by Borrowers			
24.	Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc			
25.	Agricultural Advances Affected by Natural Calamities			
26.	Advances to Staff			

27.	Agricultural Advances			
28.	Computation of Drawing Power			
29.	Audit of Advances			
30.	Audit of Revenue Items			
31.	Income			
32.	Expenses			
33.	Disclosure of the Prior Period Items			

Notes to Add

Notes to Add

OVERVIEW

Introduction

↓

Banking Operations

↓

Accounting system of Banks

↓

Bank Audit Approach

↓

Advances & Their Audit

↓

Audit of Revenue Items

Notes to Add

Sameer was very comfortable with mobile banking app and used to do most of his banking activities from this very app. Payments of house electricity bills, Wi-fi rental bill, payments of little gifts for her mother and younger sister were all made by him using his mobile. Whenever he needed to transfer money to any of his friends as common contribution for an evening get together, he used to send money through UPI using Bhim app.

One day, he happened to visit local branch of the bank in which his account was maintained. He got a feeling that banking operations are very complex and not as simple as he used to think. Since cash deposit machine was out of order on that day, he had to deposit cash by going to the counter. It made him realise that there is a trail for every bank transaction.

Huge volume of bank transactions take place instantly, moneys are deposited and withdrawn from accounts. One can access one's account from any geographical location. Banks work on "Core Banking Solution" platforms which make transactions to happen on such a scale by ensuring customer ease. Deliberating upon it, he also thought about processes, controls and automation which makes all this possible.

He was trying to understand broad working of a bank. A bank accepts deposits from its customers and lends money to trade, industry, farmers, needy sections of society and to members of general public. The rate at which a bank pays interest on deposits to customers is lower than the rates at which it charges interest on advances. The spread is used to meet establishment and administrative costs of a bank leaving out profits. In making available money to different sections of society including trade and industry, banks act as drivers of economic growth of country.

Lending of money by a bank leads to reflection of "assets" in form of advances in financial statements of a bank. He had heard the term "non-performing assets" (NPAs) quite a number of times. What do these denote and what is their significance from the point of view of an auditor? Are there some regulatory norms relating to NPAs? Meanwhile, his attention also moved towards encompassing outreach of audit in case of banks. Audit of banks appeared to be special because of huge volume of transactions, extensive use of technology, wide geographical spread of banks and other factors peculiar to banks. Excited, he was thinking of prospects to conduct audit of a bank some day in future!

Notes to Add

INTRODUCTION

- Banking Sector
  - Economy → Back Bone
  - Economy → Socio-Economic Growth
  - Economy → Financial Stability
  - Mammoth → Amt. of Money

Types of Bank

- **Banks**
  - → **Commercial**
    - → **Deposit**
    - → **Advance**
  - → **Small finance** → **Unorganised sector**
  - → **RRB** → **Rural**
  - → **Development** → **Infra. Facility**
  - → **Payment** → **Cannot issue**
    - → **Loans**
    - → **Credit Cards**
  - → **Co-Operative**
    - → **Co-op Principles**
    - → **MSCOS**

- → RBI → Regulating Body
  - Central Bank → RBI
  - → Function
    - → Issuance of ₹
    - → Regulation of ₹
    - → Banker
      - → CG
      - → SG
    - Dev. & Supervision
    - Monetary Policies
    - Regulating Commercial Banks

- → Peculiarities
  - → Huge Vol. + Complexity
  - → Wide geographical spread
  - → Large range
  - → Use of technology
  - → Strict vigilance

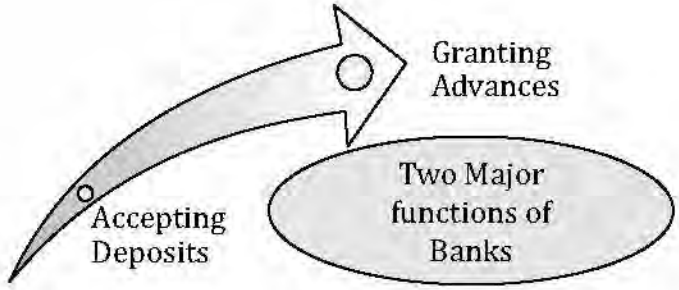
Banking sector is the backbone of any economy as it is essential for sustainable socio-economic growth and financial stability in the economy. The banking sector is also crucial as it deals with mammoth amounts of public monies and is highly sensitive to reputational risk. Like all economic activities, the banking sector is also exposed to various risks in its operations. It is of utmost importance to ensure that banking sector stays healthy, safe and sound. 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:

Commercial Banks	Regional Rural Banks
Co-operative Banks.	Payment Banks.
Development Banks (more commonly known as 'Term-Lending Institutions').	Small Finance Banks.

1. **Commercial banks** 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.
2. **Regional Rural Banks known as RRBs** are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities. Examples are:- Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc.
3. **Co-operative Banks** 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 are :- The Gujarat State Co-operative Bank Ltd., Chhatisgarh Rajya Sahakari Bank Maryadit, etc.
4. **Payments Banks** 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 & Mobilebanking. Examples are :- Airtel Payments Bank , India Post Payments Bank, Paytm Payments Bank , etc.
5. **Development Banks** had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country. Examples are:- Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI), etc.
6. **Small Finance Banks** have been set up by RBI to make available basic financial and banking facilities to the unserved and unorganised sectors like small marginal farmers, small & micro business units, etc. Examples are:- Equitas Small Finance Bank , AU Small Finance Bank , etc.



Accepting Deposits

Granting Advances

Two Major functions of Banks

Notes to Add

Reserve Bank of India: Regulating Body

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.

RBI is responsible for:

- development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions)
- determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour.
- regulating the activities of commercial and other banks

Important functions of RBI are:

- issuance of currency;
- regulation of currency issue;
- acting as banker to the central and state governments; and
- 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.

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.

Independent audit of financial statement of banks is important for a healthy, safe and sound banking system.

Banking Operations - Conducted only at Branches

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. These controlling/ administrative offices 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.

Regulatory Framework:

Banking Regulation Act, 1949. State Bank of India Act, 1955.

Companies Act, 2013.

Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.

Regional Rural Banks Act, 1976.

Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

Information Technology Act, 2000. Prevention of Money Laundering Act, 2002.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

Credit Information Companies Regulation Act, 2005.

Payment and Settlement Systems Act, 2007.

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.

Peculiarities Involved

Huge volumes and complexity of transactions;

Wide geographical spread of banks' network; Large range of products and services offered; Extensive use of technology;

Strict vigilance by the banking regulator etc.

Notes to Add

Notes to Add

Types of Audit Reports Banks
- Statutory Audit Report → as per SA 700, 705, 706
- Long form Audit Report (LFAR)
- Tax Audit Report as per the Income Tax Act, 1961

Notes to Add

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:

(a) 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.

(b) Long Form Audit Report. (LFAR)

(c) Report on compliance with SLR requirements.

(d) 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.

(e) 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.

(f) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.

(g) 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.

(h) Report on instances of adverse credit-deposit ratio in the rural areas.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

1. RBI has been entrusted with the responsibility of regulating the activities of commercial banks only.

Ans. (Incorrect)

RBI has been entrusted with the responsibility of regulating the activities of commercial and other banks. All the Banks and even NBFC's fall under the regulatory function of RBI.

Theory Questions

2. 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. Explain

Ans. 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.

RBI is responsible for :-

1. Development and supervision of the constituents of the Indian financial
2. System (which comprises banks and non-banking financial institutions)

3. Determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour.
4. Regulating the activities of commercial and other banks

Important functions of RBI are:

1. Issuance of currency;
2. Regulation of currency issue;
3. Acting as banker to the central and state governments; and
4. 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.

   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.

UNDERSTANDING OF ACCOUNTING SYSTEM BANKS

- Any time – Anywhere Banking
- Core Banking Technology

From the time that customers had to physically visit and deal with a bank, there is a sea change in banking as use of technology and its continuous evolution has enabled banks to reach their customers in providing them the convenience and comfort of anytime-anywhere-banking by letting them access their information/data on real time basis, as stored in a safe and secure environment on the bank's servers. With many customers having access to Internet and mobile connectivity, monetary transactions from inception to finish have become expeditious through E-banking; but for Core banking technology and extensive advancement therein and the availability and extensive use of technology tools, banks could not have achieved such phenomenal and accelerated growth, and could not have ventured into and offered a wide range of innovative products and services to their customers.

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 errors, omissions, irregularities and frauds. Considering the challenges of technology, bank managements continuously endeavor to make their internal control systems robust, safe and secure as well as convenient and expeditious for the customers.

In the computerized environment, it is imperative that the auditor is familiar with and 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. 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 the required parameters.

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.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

3. In the computerised environment, the auditor need not be familiar with latest applicable RBI guidelines.

Ans. (Incorrect)

In the Computerised 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.

Theory Questions

4. "The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and to assess the potential for material misstatements of the financial statement. All these discussion should be appropriately documented for future reference". Explain.

Ans. All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement are known to be the "Engagement Team". The engagement team shoul hold dicussions 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. All these discussions shouled be appropriately documented for future references.

Notes to Add

BANK AUDIT APPROACH

(1) Drawing Audit Plan → Based on
- → Nature + Level → Operation
- → Nature → Adverse features
- → Level of Compliance → P.Y.
- → Audit Risk

(2) Control Env. → Questions/Steps
- → Who
  - → Perform Control
  - → Knowledge + Authority
- → What → Evidence
- → When → Frequency ? → Enough?
- → Where
  - → A.E. → Retained + Accessible
  - → How long
- → Why
  - → Controls
  - → Type of Errors
    - → P
    - → D
- → How
  - → Controls → Performed
  - → Bypassed
  - → Exceptions → Identified

The following are certain common questions/steps, which have to be kept in mind while undertaking/ performing control activities:

(3) Engagement Team Discussion →
- **(1) Likely** → **Errors**
- **(2) P.Y.** → **Errors**
- **(3) Methods** → **Fraud**
- **(4) Responses** → **Risk**
  - → **Engagement**
  - → **Pervasive**
  - → **Specific**
- **(5) Prof. Skepticism** + Alert

Engagement Team Discussion
- → **Personnel**
- → **Experts**

Performing

→ **ADVANTAGES**
- **Susceptibility** ↓ **Fraud**
- **Delegation** ↓ **Work**
- **Specialists** ↓ **Needed**

Notes to Add

1. **Drawing an Audit Plan:** An audit plan should be drawn up based on:
   - the nature and level of operations,
   - nature of adverse features,
   - level of compliance based on previous reports and
   - audit risks based on inadequacy in or breach of internal controls and the familiarization exercise carried out,
2. **Control Environment at the Bank:** A bank should have appropriate controls to mitigate its risks, including effective segregation of duties (particularly, between front and back offices), 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.

Nature of Questions	Questions to be considered/answered
Who	❑ Who performs the control? ❑ Does the above person have requisite knowledge and authority to perform the control?
What	❑ What evidence is available to demonstrate/prove that the control is performed?
When	❑ When and with what frequency is the control performed? ❑ Is the frequency enough to prevent, detect and correct risk of material misstatements?
Where	❑ Where is the evidence of performance of the control retained? ❑ For how long is the evidence retained? ❑ Is the evidence accessible/available for audit?
Why	❑ Why is the control being performed? ❑ What type of errors are prevented or detected through the performance of the control?
How	❑ How is the control performed? ❑ What are the control activities? ❑ Can these activities be bypassed? ❑ Can the bypass, if any, be detected? ❑ How are exceptions/deviations resolved on identification? ❑ What is the time frame for resolving the exceptions/deviations?

3. **Engagement Team Discussions:** All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement are known to be the "Engagement Team". 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. All these discussions should be appropriately documented for future reference. The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's branch 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:

- 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.
- 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.
- Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

5. The auditor can assume that the system generated information is correct and relied upon.

Ans. (Incorrect)

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 for the time being in force and applicable.

Theory Questions

6. Write a short note on reversal of income under bank audit.

Ans. 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.

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.

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).

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 whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

Notes to Add

INCOME RECOGNITION POLICY

Should be Objective (on recovery) → rather than → Subjective by the books

Eg.: NPA → Immaterial Income → is recorded → when received → Not on Accrual Basis

FORM AND CONTENT OF FINANCIAL STATEMENTS

Form & Content of Financial Statement

- B/S.
- P/L

Third schedule

(Sec.29(1) & 29(2) of The Banking Regulation Act, 1949) + Sec.133 of The Companies Act, 2013 + Rule 7 of the Companies (Accounts) Rules, 2014 (Accounting Standards)

Notes to Add

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....

AUDIT OF ACCOUNTS

Audit of Banks (Sec.30(1)

By Chartered Accountants → Duly qualified → to be appointed as Auditor of a Co.

ELIGIBILITY, QUALIFICATIONS AND DISQUALIFICATIONS OF AUDITOR

As per Sec.141 of The Companies Act, 2013

Applicable as to a Company Auditor

Appointment of Auditor

- Banking Co. → AGM
- Nationalised Bank → BoD

(Banking Co. and Nationalised Bank) — Prior approval of RBI

- SBI → C & AG in consultation with CG
- Subsidiaries of SBI → SBI
- RRB → RRB → With approval of CG

Remuneration of Auditor : banking Co. → As per Sec.142 of The Companies Act, 2013

→ By Co. in

- GM
- Manner determined in GM

Nationalised Banks, SBI — RBI in consultation with CG

The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Income from non- performing assets (NPA) is not recognized on accrual basis but is booked as income only when it is actually received. (Dealt in detail later on)

Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These sub-sections are also applicable to nationalised banks, State Bank of India, and Regional Rural Banks.

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. 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.

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.

Sub-section (1) of section 30 of the Banking Regulations Act, 1949 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.

(a) 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).

    The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government.

Notes to Add

Notes to Add

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....

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AUDIT REPORT

Nationalised Banks + SBI → CG

Points to be included

(i) F.S. → True and Fair
→ Satisfactory → Info. + Explanation

(ii) Transaction done by bank → were within powers of bank

(iii) Returns required from → Offices → Branches → Adequate

(iv) Any other Matter → as per CG

FORMAT OF REPORT

Format of Audit Report : (Same as Ch. 8 (13 Points)

+

Complies with SA

Unaudited branches → Info.
→ Quantification of → Advances → Deposits
→ Interest → Income → Expense

Matters covered u/s 143 of The Companies Act, 2013

CARO 2020 → Not Applicable

Notes to Add

....

Long Form Audit Report

To be submitted in addition to the above → before 30th June every year

Matters to be included → specified by RBI

↓

Demarcration

POWERS OF AUDITOR

Same as Co. Auditor powers (5 Points)

The auditor of a banking company, nationalised bank, State Bank of India, or regional rural bank has the same powers as those of a company's auditor in the matter of access to the books, accounts, documents and vouchers.

In the case of a nationalised 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 nationalised bank.

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. 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. 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.

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.

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.

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). 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.

The Statutory Central Auditors are required to submit the LFAR to the banks latest by 30th June every year. To ensure timely submission of LFAR, proper planning for completion of the LFAR is required. 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.

Test Your Understanding

1. The financial statements of a bank are prepared in a specified format. Discuss legal provisions in this regard as applicable to financial statements of a nationalized bank.

Ans. Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These provisions are also applicable to nationalised banks. 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. 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.

Notes to Add

Notes to Add

REPORTING TO RBI

Committee on Legal Aspects of Bank Frauds

↓

Recommendation

↑

RBI issued circular → Applicable → Scheduled Commercial Banks → Except: RRB

↓

If an Accounting Professional → Course of → Internal / External / Institutional ← Audit

↓

Finds anything

- **Anything susceptible to fraud**
- **Fraudulant Activity**
- **Act of Excess power**
- **Foul play**

Refer matter to RBI

- Consider SA 250 – "Consideration of laws & Regulations in an Audit of F.S."

  ↓

  Confidentiality is overridden by → Statute / Law / Courts

  SA 240 – "Auditor's Responsibility relating to Fraud in an audit of F.S."

  ↓

  Inform RBI + Chairman / MD / CEO of Bank

Notes to Add

- Follow Sec. 143(12) of the companies Act, 2013

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 courts.

3. SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" states 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.

   It must be noted that auditor is not expected to look into each and every transaction but to evaluate the system as a whole. 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.

Notes to Add

CONDUCTING AN AUDIT

Stages

(1) Initial consideration by statutory Auditor

- **Declaration of indebtness**
- **Internal Assignment in bank by statutory Auditor**
- **Planning as per SA-300 'Planning an Audit of F.S." → Prior Activities**

Perform procedures required by SA-220 'Quatity control for Audit work'

SA-210 'Agreeing to the terms of Audit Engagement'

- **Communication with previous Auditor → Clause (8), Part I, First Schedule of The Chartered Accountants Act, 1949**

  - SA-510 'Initial Engagement – Opening Balance' → Mismatch → If not properly accounted → Qualified / Adverse Opinion
  - Assessment of Engagement Risk
  - Establishing engagement team
  - Understanding bank & its Environment → SA-315 'Identifying & Assessing the RoMM through understanding the Entity & its environment

(2) SA-315 → Identifying & Assessing RoMM at

F.S. Level

Assertion Level for → **Class of transaction** / **A/c. Balance** / **Disclosure** → **for designing audit procedures**

(3) Understanding Bank + its Environment + Internal Control to → **Identify & Assess Risk** / **Plan to determine** → **Effectiveness of control** / **Address specific Risk**

(4) Understanding the Bank's Accounting Process

5. Understanding Risk Management Process
   - Involvement & Oversight in the control process by TCWG → written policies
   - Identification, Measurement & Monitoring Risk → Against pre-approved → limits → criterias
   - Control Activities
   - Monitorin activities
   - Reliable Info. System
6. Engagement team discussion
7. Establish overall audit strategy
8. Develop Audit Plan SA-300 → SA-220 → SA 210
9. Audit Planning Memorandum
10. Determine Audit Materiality

Read all these points after the entire Audit Syllabus

11. Consider going concern
12. Assess Risk of Fraud including money laundering
13. Assess specific Risk
14. Risk associated with outsourcing of activities
15. SA-330 'Auditor's Response to assessed Risk'
16. Stress Testing
17. Basel – III framework
18. Reliance on → Review of → other report

Notes to Add

The audit of banks or their branches involves the following stages –

1. **Initial consideration by the statutory auditor**

   (*i*) **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.

   (*ii*) **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).

   (*iii*) **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".

   (*iv*) **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.

   (*v*) **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.

   (*vi*) **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 affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

   (*vii*) **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 affects the decision of accepting the engagement and also in planning decisions if the audit is accepted.

   (*viii*) **Establish the Engagement Team:** The 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.

   (*ix*) **Understanding the Bank and its Environment:** 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, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error and sufficient to design and perform further audit procedures.

2. **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.
3. **Understanding the Bank and Its Environment including Internal Control:** An understanding of the bank and its environment, including its internal control, enables the auditor:
   - to identify and assess risk;
   - to develop an audit plan so as to determine the operating effectiveness of the controls and to address the specific risks.
4. **Understanding 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.
5. **Understanding the Risk Management Process:** Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:
   (*a*) **Oversight and involvement in the control process by those charged with governance:** Those charged with governance (Board of Directors / 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*) **Identification, measurement and monitoring of risks:** Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.

   (*c*) **Control activities:** A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), 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*) **Monitoring activities:** 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*) **Reliable information systems:** 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.

6. **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.
7. **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 effective manner. For this purpose, the audit engagement partner should:
   - establish the overall audit strategy, prior to the commencement of an audit; and
   - Involve key engagement team members and other appropriate specialists while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.
8. **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.
9. **Audit Planning Memorandum:** The auditor should summarise the audit plan by preparing an audit planning memorandum in order to:
   - Describe the expected scope and extent of the audit procedures to be performed by the auditor.
   - Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.
   - Provide evidence that they have planned the audit engagement appropriately and have responded to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.
10. **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.
11. **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.
12. **Assess the Risk of Fraud including Money Laundering:** As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately.

    The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

    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 recognise and report money laundering activities.

13. **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 affect many assertions.

14. **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 effectively manage those risks.

15. **Response to the Assessed Risks:** 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. 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.

16. **Stress Testing:** 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 (Source – Wikipedia). 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.

17. **BASEL III framework:** Basel norms or accords are the International Banking regulations issued by the BCBS. 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. 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.

    The set of agreement by the BCBS, which mainly focuses on risks to banks and the financial system are called Basel accord.

18. **Reliance on / review of other reports:** The auditor should take into account the adverse comments, if any, on advances appearing in the following-

    - Previous year's audit reports.
    - Latest internal inspection reports of bank officials. Reserve Bank's latest inspection report.
    - Concurrent / Internal audit report.
    - Report on verification of security.
    - Any other internal reports specially related to particular accounts.
    - 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.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

7. Collateral security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank.

Ans. Incorrect: 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.

8. Registered mortgage is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

Ans. Incorrect:

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.

9. Auditor of a Nationalised bank is to be appointed at the annual general meeting of the shareholders.

Ans. Incorrect:

Auditor of a nationalized bank is to be appointed by the bank concerned acting through its Boards of Directors and approval of the Reserve bank is required before the appointment is made.

Theory Question

10. What are the general requirements of an effective Risk Management System in Banks?

Ans.

(*a*) **Oversight and involvement in the control process by those charged with governance:** Those charged with governance (Board of Directors/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*) **Identification, measurement and monitoring of risks:** Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.

(*c*) **Control activities:** A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), 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*) **Monitoring activities:** 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*) **Reliable information systems:** 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.

Notes to Add

ADVANCES

Advances

↓

Amt. of Money / Credit Given as Loan → from a Bank

↓

to another party

↓

Agreement → Money will be repaid

* Types of Advances

Funded

↓

Actual transfer of funds

↓

From Bank → To Borrower

Non Funded

↓

L.C.

B.G.

Notes to Add

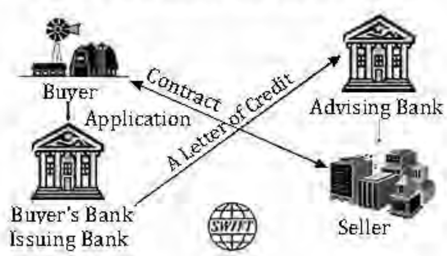
In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts, however, need to be examined in detail unless the amount involved is insignificant. The extent of sample checking would also depend on the auditor's assessment of efficacy of internal controls. What constitutes a 'large advance' would need to be determined in the context of volume of operations of the branch e.g. an advance may be considered to be a large advance if the year-end balance is in excess of ₹ 10 crore or 10% of the aggregate year-end advances of the branch, whichever is less.

Lending constitutes a major activity of a bank besides the investment function. The core business of banks is accepting deposits for onward lending. 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. Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are major source of its income. 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: Funded Loans & Non-Funded Loans

- **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.
- **Non-funded** facilities are those which do not involve such transfer. Examples of non-funded loans are Letters of credit, Bank guarantees, etc.

A Letter of Credit



Notes to Add

What do Advances comprise

- Term Loans
- CC/OD/ Demand Loans
- Bills
  - Discounted
  - Purchased
- Risk sharing Basis
- Staff Loans → Interest bearing

Notes to Add

- Classification of Advances
  - Sector Wise
    - Priority
    - Non Priority
  - Security Wise
    - Secured
    - Unsecured
  - Prudential Norms
    - Standard
    - NPAs

Notes to Add

Advances comprise of funded amounts by way of:

- Term loans
- Cash credits, Overdrafts, Demand Loans
- Bills Discounted and Purchased
- Participation on Risk Sharing basis
- 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. I. Advances in India:	C. II. Advances outside India:
(i) Priority sectors	(i) Due from Banks
(ii) Public sector	(ii) Due from Others:
(iii) Banks	(*a*) Bills Purchased and discounted
(iv) Others	(*b*) Syndicated loans
	(*c*) Others

Notes to Add

- Sector wise
  - Priority sector
  - Non-Priority Sector
- Security wise
  - Secured
  - Unsecured
- Prudential Norms wise
  - Standard Assets
    - Standard Regular
    - Special Mention A/c. (SMA)
      - SMA-0 (A/c. showing stress signal)
      - SMA-1 (Overdue b/w. 31 to 60 days)
      - SMA-2 (Overdue b/w 61 to 90 days)
  - Non-performing assets (NPA)
    - Sub standard Assets
    - Doubtful Assets
      - D1
      - D2
      - D3
    - Loss Assets

Nature of Security
- Primary → Principal Security for an Advance
- Collateral → Additional Security

Notes to Add

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
- Goods/Stocks/Debtors/Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

1. **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

(a) **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.

(b) **Collateral security** is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Notes to Add

MODE OF CREATION OF SECURITY

(1) Mortgage Deed
- Registered→By Mortgage Deed
- Equitable→By mere Delivery

(2) Pledge→Bailment or Delivery of Goods→By borrower→ to lending bank

↓

Ownership remains with the pledger

(3) Hypothecation →Creation of an equitable charge →Ownership→possession →Not transferred

(4) Assignment →Transfer of an existing
- Debt
- Right
- Property

Belonging to a person →In favour of another

(5) Set-off →Debit Balance of Debtor's A/c →Set off → Credit Balance → In the same name + Right

(6) Lien →Legal charge with consent of owner

Notes to Add

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:

(i) Mortgage: Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.

- 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.
- 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.

(ii) 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.

(iii) Hypothecation: 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 favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank.

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.

(iv) Assignment: Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person. 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.

An assignment gives the assignee absolute right over the moneys/debts assigned to him.

(v) Set-off: 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. 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 same right (i.e., the capacity of the account holder in both the accounts should be the same).

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.

(vi) 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.

Notes to Add

PRUDENTIAL NORMS ON INCOME RECOGNITION, ASSET CLASSIFICATION AND PROVISIONING PERTAINING TO ADVANCES

Prudential Norms on
- Income Recognition
- Asset Classification
- Provisioning pertaining to advances

(i) NPA → When Income is NOT generated for the bank

Term Loan / Bill Discounted → Interest + Principal → Overdue > 90 days

OD / CC A/c. → Out of order

(ii) Out of order → O/S Balance > Sanctioned Limit (SL) / Drawing Power (DP)

↑

Continuously

O/S Balance < SL/DP

But

No credit continuously for 90 days as on B/S date

OR

Credit not onough to cover Interest debited for 90 days

(iii) Overdue → Amount not paid on the due date fixed by the bank

→ Account regularised before B/s date → without subjectivity → NPA Deemed

↓

Solitary or few credits

→ If loan backed by CG → always standard asset → If guarantee continues

↓

Could be NPA on Income recognition purpose

SG → Would be NPA → If over due > 90 days

- Provisioning
- Income Purposes

Classification of Advances as per RBI Prudential Norms

Classification of Advances as per Prudential Norms
- **Standard Loans**
  - Standard Regular
  - SMA-Special Mention Accounts
    - SMA 0 (Accounts showing stress signals)
    - SMA 1 (Overdue between 31 to 60 days)
    - SMA 2 (Overdue between 61 to 90 days)
- **NPA Loans**
  - Sub-Standard
  - Doubtful (D1/D2/D3)
  - Loss Asset

Categories of NPA	Provisions Required
Standard Asset NPA < 12 months	15%
Doubtful Asset Substandard > 12 months D1 → up to 1 year D2 → 1 to 3 year D3 → more than 3 year	Secured + Unsecured 25% + 100% 40% + 100% 100% + 100%
Loss Assets Certified by → Auditor → Bank → RBI + Amount has not been fully written off	100%

(i) 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:

- interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan;
- the account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/ CC);
- the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.

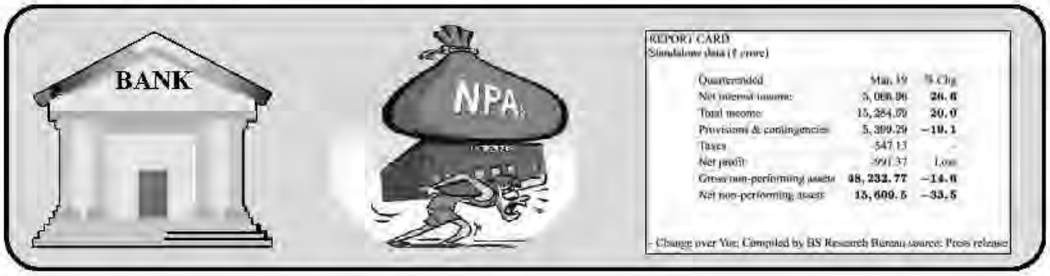
(ii) Out of Order: An account should be treated as 'out of order' if:-

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- 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
- credits are there but are 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 :-

- the outstanding balance remains continuously in excess of the INR 50 lacs/42 lacs whatever the case may be; or
- 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
- 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.

(iii) 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.



Categories of Non-Performing Assets:	Provision required
❑ **Substandard Assets:** Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
❑ **Doubtful Assets:** Would be one, which has remained in the substandard category for a period of 12 months. **Sub-categories:** Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	(Secured + Unsecured) 25% + 100% 40% + 100% 100% + 100%
❑ **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%

Note:

1. **Classification as NPA** should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise.
2. Asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

   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).

(iv) Accounts regularized near the Balance Sheet Date: The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as NPA. 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.

(v) Government Guaranteed advances:-

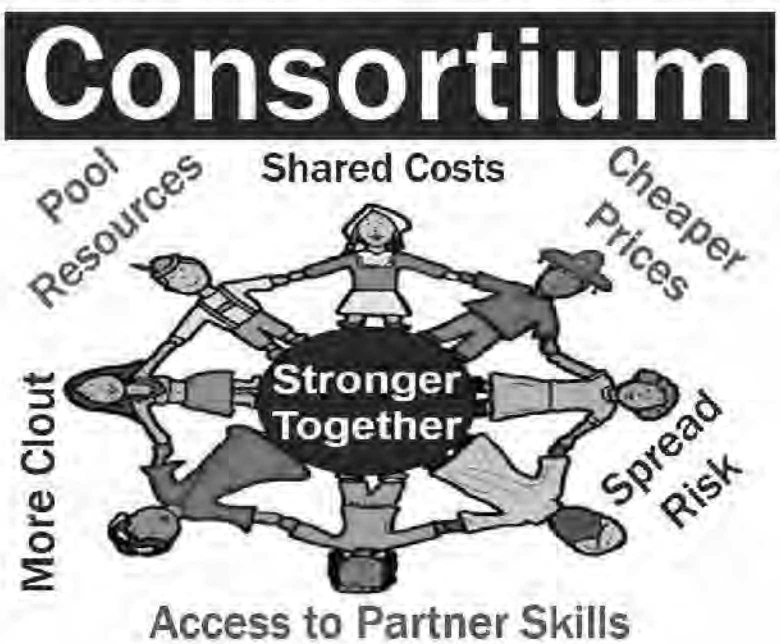
- Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.
- The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

(vi) Advances under Consortium:

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.

Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. 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.

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 advances. The proforma DP Allocation Letter is presented hereunder for reference:

Illustrative Drawing Power for December 2022as per Stock Statement November, 2022

			(₹ in Crores)
Description of Stocks	**Market Value**	**Margin**	**Advance Value**
Raw Materials	636.27	25	477.20
Finished Goods	372.75	25	279.56
Stock in process	659.35	25	494.51
Stores and Spares	124.51	25	93.38
Book Debts (Upto 120/180 days)	37379.90	35	24296.94
Stock in Transit	52.31	25	39.23
Total	39225.09	25680.82	
Less: Unpaid Stocks under LC	0.00	100	0.00
Total	39225.09	25680.82	

		(₹ 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 Paribas	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

Notes to Add

ACCOUNTS WHERE THERE IS EROSION IN THE VALUE OF SECURITY / FRAUDS COMMITTED BY BORROWERS

Value of Security eroded / fraud committed by borrower

- Realisable value < 50% of Assessed value → Doubtful category
- Realisable value < 10% of O/S → Loss Asset category

ADVANCES AGAINST TERM DEPOSITS, NSCS, KVPS/ IVPS, ETC.

Advance against Term Deposit / NSCs / IVPs / KVPs

Not treated as NPA → Provided adequate margin is available

Agricultural advances affected by natural calamities

Master circular of RBI → Banks may decide
- Conversion of short term loan into long term
- Reschedulement of Repayment period
- Sanctioning of fresh short term loan

↓

NPA as per rescheduled terms

Agricultural Advances

- Long crop season → Duration > 1 year → NPA if overdue for 1 crop season
- Short crop reason → NPA if overdue for 2 crop season

Advance to staff
- As a Banker → Include in Advances
- As an Employer → Include in sub heading 'others' under 'Other Assets'

Notes to Add

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 :-

(i) 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.

(ii) 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 off or fully provided for by the bank.

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.

Master Circular issued by the RBI deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, viz., conversion of the short term production loan into a term loan or re-schedulement 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. In such cases, the NPA classification would be governed by such rescheduled terms.

Agricultural Advances Affected by Natural Calamities

Interest-bearing staff advances as a banker should be included as part of advances portfolio of the bank. 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. 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. 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.

Advances to Staff

As per the guidelines, Agricultural Advances are of two types:

1. Agricultural Advances for "long duration" crops; and
2. Agricultural Advances for "short duration" crops.

Agricultural Advances

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.
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.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

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
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.

Test Your Understanding

2. Ranjana Ceramic Private Limited is sanctioned a cash credit facility of ₹100 lacs from a branch of LMO Bank. Besides, branch has also sanctioned a one-time bank guarantee of ₹ 10 lacs on behalf of the company in favour of a statutory authority. Discuss, what type of credit facilities have been sanctioned by branch of LMO bank to the company along with probable purpose for each of credit facility.

Ans. Cash credit facility sanctioned by bank to company is in nature of funded credit facility. Its purpose is to meet working capital requirements of business.

Bank guarantee sanctioned to the company is in nature of non-funded credit facility. Its probable purpose could be requirement of a guarantee by a statutory authority in exchange of company fulfilling some statutory obligations.

3. During course of audit of branch of a nationalized bank, you find that system has generated a report marking ten term loan accounts as SMA. Discuss, meaning of SMA accounts and significance of such a classification.

Ans. Special Mention Account (SMA) is an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of debt obligations, though the account has not yet been classified as NPA as per the RBI guidelines.

In the given case, ten term loan accounts have been classified as SMA. It means that there are overdues in the accounts for a period of 0 to 90 days. Since period of 90 days has not been exceeded as on the date, such accounts have not been classified as NPA as per RBI norms.

Such a classification is significant as early recognition of such accounts enables banks to initiate timely remedial actions to prevent potential slippages of such accounts into NPAs.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

11. Bank recognize income on Non-performing assests on accrual basis

Ans. Incorrect:

Income from non-performing assets (NPA) is not recognised on accrual basis due to its uncertainty but is booked as income only when it is actually received.

12. Any amount due to the bank under any credit facility is 'overdue' if it is not paid within 90 days of becoming due.

Ans. Incorrect:

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

Theory Question

13. The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. Explain this statement.

Ans. Auditing the Operating Expenses of a Bank:-

(a) Internal Controls: 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.

(*b*) Divergent Trends: The auditor should examine whether there are any divergent trends in respect of major items of expenses.

(*c*) Substantive analytical Procedures: The auditor should perform substantive analytical procedures in respect of these expenses. eg. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

(*d*) Vouching & Verification: The auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.

14. CARD Ltd. is into the banking business and handles large amount of loans and advances of different kinds. Nonperforming assets are on the rise since last two quarters. The management is concerned with correct provisioning for the same. CA R is appointed to check whether correct provisioning of NPA's is being made by the bank or not. What are the aspects that will be verified by CA R for this purpose?

Ans. Provisioning of Non-performing Assets:

CA R should verify that the classification of NPAs into sub-standard assets, doubtful assets and loss assets is done depending upon prudential norms as per the RBI Guidelines. Further he should also ensure that provis ion is being made for the same in accordance with the given table:

Categories of Non-Performing Assests: Substandard Assests:	Provision required
Would be one, which has remained NPA for a period less than or equal to 12 months	15
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%
Loss Assets:	
Would be one, where loas 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%

Alternative Answer 1:

Aspects to be verified by CA R to check correct provisioning of NPAs: CA R should verify following aspects while checking whether correct provisioning of NPAs is being made by bank: -

1. It should be verified whether classification of NPAs is in accordance with RBI guidelines. Such guidelines require classification of NPAs into sub-standard assets, doubtful assets and loss assets depending upon different criteria. Each classification requires different percentage of provisions. Therefore, proper classification of NPAs would ensure that provisioning is correct.
2. It should be verified that doubtful assets have been further properly classified in D1, D2 and D3 categories. These three different categories require provision of 25%, 40% and 100% respectively of secured portions of outstanding amount.

3. It should be verified that secured and unsecured portion in doubtful assets have been arrived at properly. Unsecured portion of liability entails provision of 100%. Therefore, it is important to verify that break-up of doubtful assets into secured and unsecured portions is proper.
4. As different kinds of loans and advances are handled by the bank, it should be ensured that loan classification according to its purpose is properly made in the system. NPA norms vary for cash credit accounts, term loans, bills purchased and agricultural loans. Any wrong classification can lead to incorrect provisioning. For example, if an agricultural loan is wrongly classified, it would lead to incorrect provisions.

Alternative Answer 2:

Aspects to be verified by CA R to check correct provisioning of NPAs:

1. For audit of Provisions, 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. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets.
3. The auditor may verify the loan classification on a sample basis.
4. The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.

Notes to Add

COMPUTATION OF DRAWING POWER

Computation of Drawing Power

- All accounts → Kept under → SL / DP
  Exceptions / Against unapproved securities → Inform Mgt. / HO
- Current Assets → Adequate →IF DP in working capital
  DP based up on → Current Stock statement →not exceeding 3 months
- Stock statement → to be scrutinized → in detail
- Annual report → Compare ← Monthly stock statement
  ↓
  Deviation to be ascertained

- Stock audit of Borrower → by bank → If Advance > ₹ 5 crore

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

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

15. An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

Ans. Incorrect: An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

16. An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

Ans. Incorrect: 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.

Theory Question

17. In a bank, all accounts should be kept within the drawing power and the sanctioned limit. The accounts which exceed the sanctioned limit or drawing power should be brought to the notice of the management regularly. Analyse the following points to be considered in the computation of drawing power in case of bank audit.

(*i*) Bank's Duties (*ii*) Auditor's concern

(*iii*) Computation of DP (*iv*) Stock audit

Ans. Computation of Drawing Power:

(*i*) 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.

(*ii*) 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.

(*iii*) 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.

(*iv*) Stock Audit: The stock audit should be carried out by the bank for all accounts having funded exposure of more than I 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.

18. Compute the Drawing Power for Cash Credit A/c of S Limited for the month of March 2022 with following information:

	(Amount in ₹)
Stock	50,000
Debtors	45,000
(Including Debtor of ₹ 5,000 for an invoice dated 17.11.2021)	
Sundry creditors	15,000
Sanctioned Limit	45,000
Margin on stock is 20% and on debtors is 50%.	

Note: Debtors older than 3 months are ineligible for calculation of DP. 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.

Ans. Computation of Drawing Power:

Computation of Drawing Power for CC A/c of S Ltd.

Particular of current assets		Amount(₹)	DP Amt(₹)
(A) Stocks			
Stocks at realizable value		50,000	
Less: Unpaid stocks:			
– Sundry creditors	15000	15000	
Paid for stocks		35000	
Margin @ 20%		7000	28000
(B) Debtors:			
Total Debtors		45000	
Total Debtors		5000	
Eligible debtors		40000	
Margin @ 50%		20000	20000
Total Drawing Power			48000

The sanctioned limit given in the question is ₹ 45000 whereas drawing power as per the above working is ₹ 48000.

So, drawing power would be restricted to sanctioned limit i.e., ₹ 45000

19. Explain the audit approach you would follow to check the Operating Expenses of a Bank.

Ans. 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.

Notes to Add

Notes to Add

AUDIT OF ADVANCES

Audit of Advances

(1) Obtain A.E. for
- **B/S figures**
- **Advance represent amount due to bank**
- **Supporting documents**
- **No unrecorded assets**
- **Basis for valuation**
  - **Appropriate**
  - **Properly applied**
  - **Recoverability**
- **Accounting**
  - **Appropriate**
  - **Recouverability**

  + Statutory & Regulatory Requirementy
  - **Disclosed**
  - Classified
  - **Discribed**
- **Provisions mode**
  - **RBI**
  - **AS**
  - **GAAP**

(2) Apply
- Substantive procedures → Large Scale Advances
- Sampling procedures → Small advances

(3) Advances
- Sanctioned during the year
- Adversely Commented by
  - RBI
  - Concurrent Auditor
  - Internal Inspection

→ Include in auditor's Review

(4) Evaluation of Internal Control (IC)
- Credit worthiness of borrower
- Executed Documents
- Compliance with T & C of Loan
- Sufficient margin of security against loan
- Transfers of names of shares if kept as security
- Registration of security in Bank's name

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.

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 which 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 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.

The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- examining the validity of the recorded amounts; examining loan documentation;
- reviewing the operation of the accounts;
- examining the existence, enforceability and valuation of the security;
- checking compliance with RBI norms including appropriate classification and provisioning; and carrying out appropriate analytical procedures.

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.

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:

- 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.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- 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.
- 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.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- 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 godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- The accounts should be kept within both the drawing power and the sanctioned limit.
- 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.
- 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.

Notes to Add

Test Your Understanding

4. CA P is conducting stock audit of a borrower availing cash credit facility of ₹100 lacs from branch of a bank. The cash credit facility is against security of paid stocks and debtors up to 90 days. Margin stipulated is 25% for stocks and 40% for debtors. Following further information is available as on 31.12.22: -

Value of stocks	₹ 125 lacs
Value of stocks (fully damaged) included in above	5 lacs
Value of debtors	50 lacs
Value of debtors exceeding 90 days included in above	10 lacs
Value of creditors for goods	50 lacs

Is Drawing Power computed by CA P for ₹ 82.50 lacs proper?

Ans. The computation of Drawing power is as under: -

Value of stocks as on 31.12.22	₹ 125 lacs
Less: value of damaged stocks	₹ 5 lacs
	₹ 120 lacs
Less: creditors for goods as on 31.12.22	₹ 50 lacs
Value of Paid stocks	₹ 70.00 lacs
Less: Margin @ 25%	₹ 17.50 lacs
Drawing power (A)	₹ 52.50 lacs
Value of debtors as on 31.12.22	₹ 50 lacs
Less: debtors exceeding 90 days	₹ 10 lacs
	₹ 40 lacs
Less: Margin @ 40%	₹ 16 lacs
Drawing Power (B)	₹ 24 lacs
Drawing Power (A+B)	₹ 76.50 lacs

The drawing power calculated by CA P is not proper. Drawing Power comes to ₹ 76.50 lacs.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

20. Banks recognize income on Non-Performing Assets on accrual basis.

Ans. Incorrect: Auditor of a nationalized bank is to be appointed by the bank concerned acting through its Boards of Directors and approval of the Reserve bank is required before the appointment is made.

AUDIT OF REVENUE ITEMS - PROFIT AND LOSS ACCOUNT

- Incomes
- Expenditure

(1) Reasonable Assurance

- Transaction of Relevant period
- No unrecorded Income
- Recorded in proper amounts
- Allocated to proper period

(2) As per RBI → Income to be recorded on Accrural basis as per AS-9
↓
which exceeds 1% of
- Total Income as per Gross Income
- NPBT if recorded as per Net of cash basis

(3) Items may be recorded on cash basis → If not material

(4) Revenue Certainity → Reasonable to expect
↓
Ultimate Collection
↓
Accrual Basis

(5) Revenue Uncertainity → Cash Basis
Provided adequate margin
↑
(6) Advances against securities → Interest → On Due Date

- Term Deposits (FD)
- NSCs
- IVPs
- KVPs
- Life Policies

(7) Bills Purchased → O/S at the close of the year
↳Discount Received → Apportioned → B/W 2 years
↳ Unexpired $\frac{\text{Discount}}{\text{Rebate on Bill Discounted}}$

(8) Bills for collection → examine procedure → Crediting the party
↓
on whose behalf
↓
Bill has been collected

(9) Renegotiations → Recognized on Accrual Basis

*** Revarsal of Income**
If Advance → becomes NPA + wrongly recognised
↳Income → should be REVERSED (Govt. Guarantee A/c also)

- **Accrued**
- **Credited**

+ Enquire → Large Debits

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.

यथा 31 मार्च, 2016 को समाप्त वर्ष का लाभ व हानि खाता

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH 20

	अनुसूची Schedule	यथा 31.03.2015 को समाप्त वर्ष For the Year ended 31.03.201 (₹000)	यथा 31.03.2016 को समाप्त वर्ष For the Year ended 31.03.201 (₹000)
I. आय / INCOME			
अर्जित ब्याज / INTEREST EARNED	13		
अन्य आय / OTHER INCOME	14		
जोड / TOTAL			
II. आप / EXPENDITURE			
व्यय किया गया ब्याज/ INTEREST EXPENDED	15		
परिचालन व्यय / OPERATING EXPENSES	16		
प्रावधान और आकस्मिक व्यय/ PROVISIONS AND CONTINGENCIES			
जोड़ / TOTAL			
III. वर्ष का निवल लाभ / NET PROFIT FOR THE YEAR			
IV. विनियोजन / APPROPRIATIONS			
निम्नांकित को अंतरण / TRANSFERS TO			
सांविधिक आरक्षित निधियाँ / STATUTORY RESERVES			
पूँजी आरक्षित निधियाँ / CAPITAL RESERVES			
निवेश आरक्षित निधि खाता / INVESTMENT RESERVE ACCOUNT			
राजस्य आरक्षित निधि / REVENUE RESERVE			
विशेष आरक्षित निधियाँ / SPECIAL RESERVE			
अंतरिम लाभांश / INTERIM DIVIDEND			
प्रस्तावित लाभांश / PROPOSED DIVIDEND			
लेखांकन नीतियाँ / ACCOUNTING POLICIES			
लाभांश कर / DIVIDEND TAX			
जोड़ / TOTAL			
लेखा संबंधी दिप्पणियाँ / NOTES ON ACCOUNTS	17		
प्रति शेयर अर्जन (मूल व ननुकूल) / EARNINGS PER SHARE (BASIC AND DILUTED) (₹में / in₹)	18		

- Partial Recoveries in NPA
  - → In absence of Agreement
    - Bank
    - Borrower
    - Adopt A/c Policy
      ↓
      AS-9
    - Right of appropriation of recoveries
      - Uniform
      - Consistent

Memorandum A/c.

Income on NPA should not be recorded or reverse if already recorded

↓

But can be recorded in memorandum A/c. → for control purposes

↓

But not to be included for calculation of Advances

Notes to Add

INCOME

The following items are included under this head:

Interest Earned	Other Income
❑ Interest / Discount on Advances / Bills: ❑ Interest Income on Investments: ❑ Interest on Balances with RBI and Other Inter–bank Funds: ❑ Others: This includes any other ❑ Not included in the above heads	❑ Commission, Exchange and Brokerage: This item comprises of the following: (*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, demat, investment advisory, cash management and other fee based services. ➢ Profit on Sale of Investments ➢ Profit/Loss on Revaluation of Investments ➢ Profit on sale of Land, Buildings and Other Assets: ➢ Profit/Loss on Revaluation of Fixed Assets Profit on exchange transactions:
	➢ This includes revaluation gains/losses on forward exchange contracts and other derivative contracts, premium income/expenses on options, etc. ➢ Income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. ➢ Miscellaneous income.

AUDIT APPROACH AND PROCEDURES

- **Auditor's Concern:-** In carrying out 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 pertained to the bank, there is no unrecorded income and the income is recorded at appropriate amount.
- **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 Accounting Standard 9.
- **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.
- **Revenue Certainty:-** Banks recognise 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.
- **Revenue Uncertainty:-** 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. 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.
- **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.
- **Bills Purchased:-** 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"]. Interest (discount) component paid by Bank/Branch on rediscount of bills from other financial institutions, is not to be netted off from the discount earned on bills discounted.
- **Bills for Collection:-** 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. 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. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection. The commission of the branch becomes due only when the bill has been collected.
- **Renegotiations:-** 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. Test check the interest earned by the banks for the sample selected. Test check the fees and commissions earned by the banks made for commission on bills for collection, letters of credit and bank guarantees.

Reversal of Income:

(a) 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.

(b) 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.

(c) 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).

(d) 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 whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action 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: A takeout loan is a method of financing whereby a loan that is procured later is used to replace the initial loan. More specifically, a takeout loan, or takeout financing, is longterm 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 (Source :- Investopedia).

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).

Notes to Add

OBJECTIVE OF TAKEOUT FINANCE

- To expand sources of Finance for infrastructure projects by facilitating participation of new entities
- To address sectoral/group/entity exposure issues and asset liabillity in mis-match concerns of tenders
- To boost the availability of longer tenor debt finance for projects

Notes to Add

On Partial Recoveries in NPAs:

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. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted.

Interest partly/fully realised in NPAs can be taken to income. 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: 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. However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes. For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

Income from Investments

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 amortisation of premium on SLR investments is net off from the interest income on investments.

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.

Profit/Loss on Revaluation of Investments: In terms of guidelines issued by the 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.

Notes to Add

EXPENSES

(I) Test Check
- → Calculation
- → Interest provided → All Deposits
- → Rates → as per
  - → Internal Regulation
  - → RBI directive
  - → Agreements
- → Saving A/c Interest
- → Inter-Branch Balance → Interest

(II) Operating Expenses

(*a*) Study + Evaluate → Sys. Of I.C.

(*b*) Examine → Divergent trends → Major Exp.

(*c*) Perform → SAP

(*d*) Verify
- → Supporting Doc^n
- → Cal^n

(III) Provisions & Contingencies

(*a*) Ensure → compliance → Regulatory Reg.

(*b*) Computation → Provision
- Standard Assets
- NPA

(*c*) Detailed, Breakup
- Standard Loan
- NPA
- Agree o/s Bal. with GLA

(*d*) Tax provision computation

Notes to Add

Expenditure is to be shown under three broad heads:

1. Interest expense
2. Operating expense
3. Provisions and contingencies.

The following items are included under this head:

Interest Expense	Operating Expenses	Provisions and Contingencies
❑ Interest on Deposits	❑ Payments to and Provisions for Employees	❑ Provisions made in respect of the Non-performing assets.
❑ Interest on Reserve Bank of India/Inter-Bank Borrowings	❑ Rent, Taxes and Lighting ❑ Printing and Stationery	❑ Provisions for Taxation
❑ Others	❑ Advertisement and Publicity	❑ Provisions for Diminution in the value of investments
	❑ Depreciation on Bank's Property	❑ Provisions for contingencies
	❑ Directors' Fees, Allowances and Expenses	
	❑ Auditors' Fees and Expenses	
	❑ Legal expenses	
	❑ Postage, Telegrams, Telephones, etc.	
	❑ Repairs and Maintenance	
	❑ Insurance	
	❑ Marketing Expenses	
	❑ Other Expenses	

Audit Approach and Procedures

- 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 analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. In modern day banking, the entries for interest expenses are automatically generated through a batch process in the CBS system.
- The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. 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 difference, if material.
- The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences. The auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter. The auditor should analyse month on month (or quarter on quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.

- The auditor should, on a test check basis, verify the calculation of interest and ensure that:
  (*a*) Interest has been provided on all deposits upto the date of the balance sheet;
  (*b*) Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;
  (*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.

The auditor should ascertain whether there are any changes in interest rate on saving accounts and term deposits during the period. The auditor should obtain the interest rate card for various types of deposits and analyse the interest cost for the period accordingly. 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. 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.

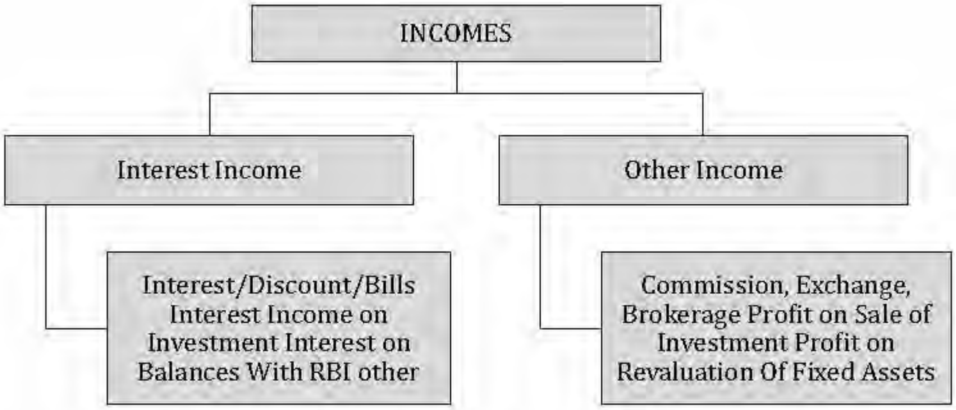
For audit of Operating expenses, the auditor should:-

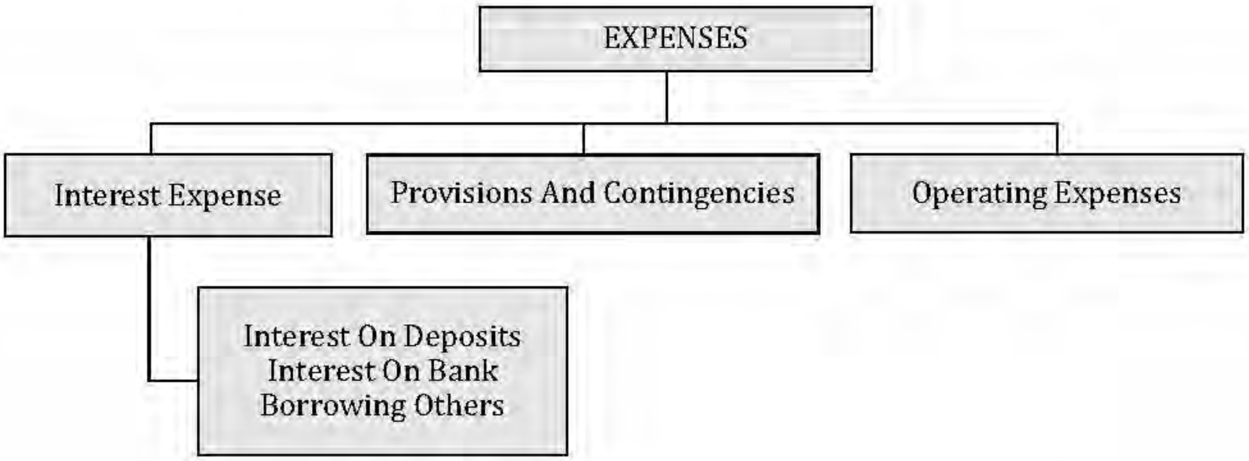
- study and evaluate the system of internal control relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.
- should examine whether there are any divergent trends in respect of major items of expenses.
- perform substantive 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.
- verify expenses with reference to supporting documents and check the calculations wherever required.

For audit of Provisions and contingencies the auditor should:-

- ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.
- obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- 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.
- 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.

Notes to Add


INCOMES
Interest Income
Other Income
Interest/Discount/Bills Interest Income on Investment Interest on Balances With RBI other
Commission, Exchange, Brokerage Profit on Sale of Investment Profit on Revaluation Of Fixed Assets


EXPENSES
Interest Expense
Provisions And Contingencies
Operating Expenses
Interest On Deposits Interest On Bank Borrowing Others

Notes to Add

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.

Test Your Understanding

5. You are verifying interest on deposits paid by branch of a nationalized bank. Discuss, any two "analytical procedures", to verify interest on deposits paid by branch.

Ans. The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. 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 difference, if material. The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

QUESTIONS

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

21. Auditor of a Nationalised bank is to be appointed at the annual general meeting of the shareholders.

Ans. Incorrect: Auditor of a nationalized bank is to be appointed by the bank concerned acting through its Board of Directors and approval of the Reserve bank is required before the appointment is made.

CA M is conducting statutory audit of branch of MMC Bank. During the course of audit, it is noticed as under:-

(*i*) Loans under "Kisan credit card" are given by Bank to farmers to meet their short-term credit needs for cultivation of crops.

In respect of one agricultural advance classified under "Kisan Credit Card" having an outstanding balance of ₹ 20 lacs as at year end, there is no transaction in account since last 90 days. The said loan has been granted for cultivation of paddy which is harvested in a period of 3-4 months from sowing. The branch has classified the said advance as "Standard asset".

(*ii*) It is also observed that account of one borrower availing cash credit limit of ₹50 lacs was taken over from another bank. The proposal was sanctioned by branch manager instead of immediate next higher authority as required in "Manual of Delegation of Powers" of Bank.

(*iii*) It is noticed that head office of bank has flagged a savings account maintained in branch in which interest was wrongly paid at higher rate due to wrong data feeding entry. Now, situation has been rectified by debiting excess interest paid in the account. Since there was little balance in savings account, a debit balance of ₹1.50 lac was created in the said savings account due to above reversal. The matter was immediately informed to account holder. However, he has not turned up for payment since matter was informed to him about six months ago.

(*iv*) There are many cash credit accounts in the branch. Such borrowers are required to submit monthly stock statements to branch showing calculation of drawing power.

(*v*) One borrower has availed a housing loan and a car loan from the branch. Housing loan EMIs are overdue for 120 days as on date of Balance sheet. Car loan EMIs are overdue for 60 days as on date of Balance sheet.

CASE STUDY

Based on above, answer following questions:

1. As regards description of agricultural advance, which of the following statements is most appropriate in this regard?

(*a*) The branch has erred in making classification as per RBI norms. It is a "Sub-standard" asset

(*b*) The classification made by branch is proper. However, there are no transactions in account since last 90 days, it is SMA.

(*c*) The classification made by branch is proper.

(*d*) The branch has erred in making classification as per RBI norms. It is a "doubtful" asset.

2. Regarding taken over account from another bank, which of following statements is most appropriate?

(*a*) It is an internal issue of Bank and auditor is not concerned with it.

(*b*) It is an internal issue of Bank. However, the auditor may, at his discretion, report it.

(*c*) It is a serious violation of laid down procedures of bank for sanction of advances and should be reported by auditor without fail.

(*d*) There is no issue involved as credit facility was properly sanctioned.

Ans. (*c*)

3. As regards debit balance of ₹ 1.50 lacs in Savings account, which of the following is correct from point of view of an auditor?

(*a*) The situation does not attract RBI norms on asset classification.

(*b*) The debit balance of ₹ 1.50 lacs should be classified as NPA.

(*c*) The situation does not attract RBI norms on asset classification as no credit facility was granted.

(*d*) The bank cannot demand excess interest paid to account holder.

Ans. (*b*)

4. Which of the following statements is not true about "drawing power" (DP)?

(*a*) Drawing Power refers to the amount calculated based on primary security less margin as on particular date.

(*b*) It is always less than sanctioned limit.

(*c*) It can be different from sanctioned limit.

(*d*) Creditors for goods are reduced for purpose of calculating Drawing Power.

Ans. (*b*)

5. Considering housing loan and car loan availed by a borrower, which of the following statements is appropriate?
   (*a*) Both Housing loan as well as car loan should be classified as "Non-Performing Assets" in accordance with RBI norms on asset classification.
   (*b*) Housing Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Car loan should be classified as Standard asset.
   (*c*) Car Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Housing Loan should be classified as Standard asset.
   (*d*) Both Housing as well as car loans should be classified as Standard assets.

Ans. (*a*)

QUESTIONS

Multiple Choice Questions (MCQ)

Test Your Knowledge

1. Which of the following is included in "Interest Earned" in Profit & loss A/c of a bank?
   (*a*) Discount on Bills
   (*b*) Loan Processing fees
   (*c*) Commission on bills for collection
   (*d*) Credit Card Fees

Ans. (*a*)

2. While auditing advances of a bank as statutory auditor, which of the following is not a likely concern of auditor?
   (*a*) Appropriate documentation of advances
   (*b*) Ensuring budgeted targets of advances given by bank management
   (*c*) Compliance of sanctioned terms and conditions
   (*d*) Operations in advance accounts

Ans. (*b*)

3. Any amount due to the bank under any credit facility is 'overdue' if:
   (*a*) it is not paid on the due date fixed by the bank
   (*b*) it is not paid within 30 days of due date fixed by the bank
   (*c*) it is not paid within 60 days of due date fixed by the bank
   (*d*) it is not paid within 90 days of due date fixed by the bank

Ans. (*a*)

4. Which of the following statement is true regarding appointment of statutory branch auditor of a nationalized bank?
   (*a*) The appointment is made by bank acting through its board of directors with prior approval of Central govt.
   (*b*) The appointment is made by bank acting through its board of directors with prior approval of RBI.

(*c*) The appointment is made by bank acting through its board of directors with prior approval of ICAI.

(*d*) The appointment is made by shareholders in AGM.

Ans. (*b*)

5. Identify the correct statement:

(*a*) Income from non-performing assets is recognized on accrual basis.

(*b*) Income from non-performing assets is never recognized.

(*c*) Income from non-performing assets is recognized on basis of actual recovery.

(*d*) Income from non-performing assets is recognized only when such assets are upgraded to standard assets.

Ans. (*c*)

Theory Questions

22. What are the general requirements of an effective Risk Management System in Banks?

Ans.

(*a*) Oversight and involvement in the control process by those charged with governance: Those charged with governance (Board of Directors/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*) Identification, measurement and monitoring of risks: Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.

(*c*) Control activities: A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), 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*) Monitoring activities: 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*) Reliable information systems: 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.

23. Explain the audit approach you would follow to check the Operating Expenses of a Bank.

Ans. Auditing the Operating Expenses of a Bank:-

(*a*) Internal Controls:- 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.

(*b*) Divergent Trends:- The auditor should examine whether there are any divergent trends in respect of major items of expenses.

(c) Substantive analytical Procedures:- The auditor should perform substantive analytical procedures in respect of these expenses, eg. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

(d) Vouching & Verification:- The auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.

24. The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. Explain this statement.

Ans. 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:

- 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.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- 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.
- 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.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- 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 godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer. The accounts should be kept within both the drawing power and the sanctioned limit.
- 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.
- 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.

❑❑❑

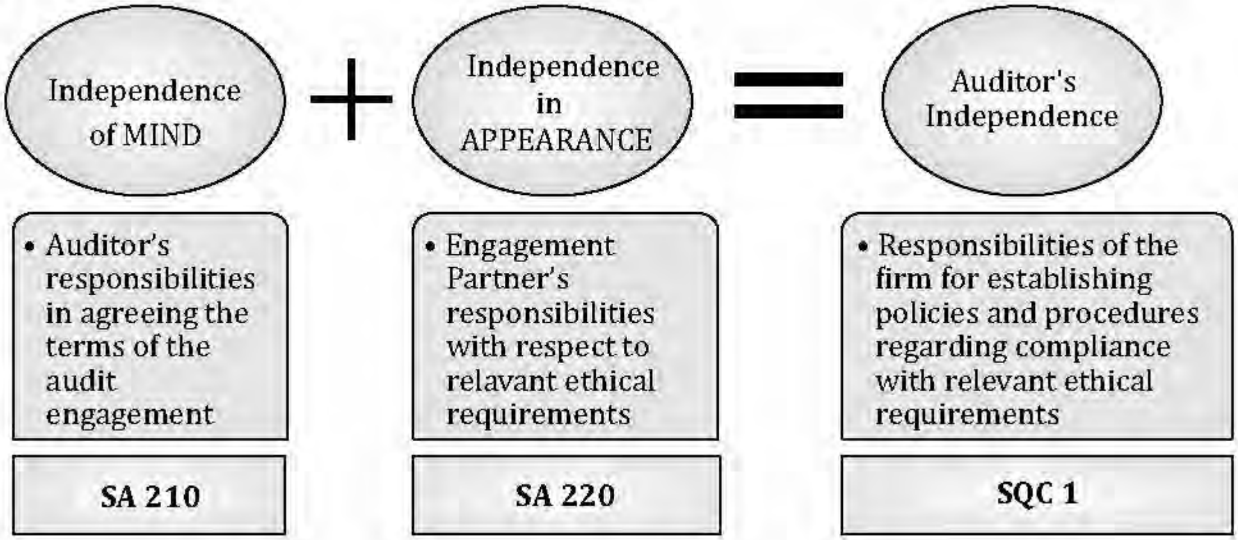
CHAPTER 11

Ethics and Terms of Audit Engagements

S. No.	Sub Topics	Easy	Moderate	Hard
01.	Meaning of Ethics			
02.	Need for Professional Ethics			
03.	Principles based approach Vs Rules based approach to ethics			
04.	Fundamental principles of professional ethics			
05.	Independence of auditors			
06.	Threats to Independence			
07.	Safeguards to Independence			
08.	Professional Skepticism			
09.	Agreeing the terms of audit engagements			
10.	Example of an engagement letter			
11.	What happens if preconditions for an audit are not present?			
12.	Limitation on scope prior to audit engagement acceptance			
13.	Acceptance of a Change in the Terms of the Audit Engagement			
14.	Request from entity to change the terms of audit engagement-When reasonable justification exists?			
15.	What should auditor consider before agreeing to change the audit engagement to the engagement providing lower level of assurance?			
16.	Recourse available to auditor in situation of non-agreement to a change in terms of engagement and lack of permission from management to continue original audit engagement			
17.	Terms of engagement in recurring audits			
18.	Audit Quality			
19.	SQC 1 – "Quality Control for firms that perform audits and reviews of historical financial Information, and other assurance and related services engagements"			
20.	Elements of System of Quality Control			
21.	SA220-"Quality Control for an audit of financial statements"			

Notes to Add

OVERVIEW



Notes to Add

Human civilization is built upon ethics. We cannot think of our daily lives without ethics. Think of any endeavour of human activity- be it imparting of education, running a business, engaging in a profession or carrying out public administration affairs- ethics have a role to play in every field. Ethics guide us and help in building trust.

Consider the case of business. Can a company which does not take care of its workforce or hear its customers achieve heights in its respective trade? A business which dishes out substandard products instead of promised ones would not be able to stay in market for too long. Or take the case of a lawyer who fails to attend legal proceedings of a client without reasonable cause putting his client's interests in jeopardy. Is his conduct ethical? Ultimately, such unprofessional behaviour would tarnish his reputation and credibility.

Sameer was trying to understand importance of ethics in profession of Chartered Accountancy. He was wondering whether a code of ethics exists for Chartered accountants and if so, how exhaustive it would be.

Based upon his understanding of auditing till now, he was certain that an auditor must comply with ethical requirements while conducting audit of financial statements. He knew that auditor should be a person of unimpeachable integrity. He gives opinion on financial statements of entities and to maintain sanctity and credibility of his signatures, it is necessary that an auditor should comply with ethics.

A parallel stream of thoughts was also gaining momentum in his mind. Should an auditor follow only those requirements which have been clearly laid down in the rule book? What about situations for which little has been laid down? Thinking about "independence" of auditors, he seemed pretty sure that it was not possible to codify every situation affecting independence of auditor. What approach should auditor follow so that users continue to repose faith? Is there more than one perspective of concept of "independence"? And most importantly, how should an auditor proceed in a situation where he finds his "independence" on a sticky wicket due to extraneous factors?

Performing professional work following ethics also leads to qualitative audits conforming to professional standards. Are there any pronouncements on quality control to be followed by Chartered Accountants? He was yearning to learn about these.

Notes to Add

MEANING OF ETHICS – A STATE OF MIND

↓

Moral Principles → Which governs
- Person's behaviour
- Conducting of an activity

- Comes Intrinsically
- Inculcated in
  - Habit
  - Temprament
- State of mind
- Science of morals
- Rules of conduct

NEED FOR PROFESSIONAL ETHICS

A CA — Practice / Service — Has to abide by ethical behaviours

↓

ICAI → requires → members → comply with principles of ethics
- codified

* Deviation → Disciplinary Mechanism
  - Fines
  - Suspension
  - Removal
  - Other

  membership

Notes to Add

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. 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. 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.

Notes to Add

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....

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. 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.

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.

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. 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. 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.

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.

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. 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.

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. The ethics for Chartered Accountants have, therefore, been codified as ethical compliance has always been a philosophy of the profession. Chartered accountants, whether in practice or in service, are required to comply with the provisions of Code of Ethics.

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)

Ethical guidance follow

Principles Based Approach	Rule Based Approach
(1) Essence = Requires compliance ↓ With sprit of ethics	(1) Strictly follows ↓ Clearly established rules
(2) Accountants → exercise ↓ Every situation ↓ Prof. Judgement ↓ Based on: Prof. knowledge, skill, Expertise → Winner	(2) Narrow outlook
	(3) Spirit of ethics ↓ Overlooked
	(4) Rigid
	(5) May not possible ↓ Every situation

FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

Establish → Expected → standard of behaviour

- **Integrity** ↓
  - ❑ Straight forward
  - ❑ Honest
  - ❑ Fair dealing
  - ❑ Truth fulness
  - ❑ False + Misleading
  - → St. ↓ Shall not knowingly associate
- **Objectivity** ↓
  - ❑ Bias
  - ❑ Conflict of interest
  - ❑ Undue influence
  - ↓ Prof Judgement ↓ Not Compromised
- **Prof. competence + Due care** ↓ Attain + maintain ↓
  - ❑ Prof. knowledge
  - ❑ skills
- **Confidentiality** ↓ Respect confidentiality of info ↓ Unless ↓
  - Req. / Permitted — By law
  - Authorised — Client / Employer
  - Prof Duty
- **Prof. Behaviour** ↓
  - ❑ Comply — Law / Regulation
  - ❑ Avoid conduct ↓ Discredit profession
  - ❑ Unknowingly engage
  - Employment / Occupation / Activity — Impair — Integrity / Objectivity / Reputation — Profession

→ Diligence = Responsibility to Act [carefully + Thoroughly + timely]

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. It requires accountants to exercise professional judgment in every situation based upon their professional knowledge, skill and expertise. 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. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules. 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.

Notes to Add

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:

Notes to Add


Confidentiality
Integrity
Professional Behaviour
Professional competence and due care
Objectivity

Notes to Add

1. **Integrity:** 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. Integrity implies fair dealing and truthfulness.

   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:** The principle of objectivity requires an auditor not to compromise professional judgment because of bias, conflict of interest or undue influence of others. 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 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.

   Diligence includes responsibility to act carefully, thoroughly and on a timely basis in accordance with requirements of an assignment.

4. **Confidentiality:** Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships. 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.

   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:** 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. A professional accountant shall not knowingly engage in any employment, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles.

Test Your Understanding

1. CA P. Suryakantam has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Discuss which fundamental principle governing professional ethics is disregarded by him.

Ans. Failure to reply to professional body smacks of lack of courtesy and professional responsibility. The principle of "Professional behaviour" is disregarded.

2. A Chartered accountant in practice issued a certificate showing original cost of plant and machinery installed in premises of a client for Rs. 9 crores to save some regulatory fees for his client. However, original cost of plant and machinery was Rs.15 crore as per records of client. Which fundamental principle governing professional ethics is violated in this case?

Ans. "Integrity" requires that 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.

In the given case, a false certificate is knowingly issued showing misstated original cost of machinery. Therefore, fundamental principle of "integrity" is violated.

INDEPENDENCE OF AUDITORS

↓

Judgement of a person → Not subordinate — Wishes / direction — Another person

↓

Engaged

↓

To own self interest

As per the code :- Auditor should be INDEPENDENT

Independence of Mind

↓

State of mind that permits the provision of an opinion → without being affected by influences

↓

Allowing individual to act with

Integrity (I) **Objectivity (O)** **Professional Skepticism (PS)**

Independence in Appearance

↓

Avoidance of facts & circumstances

↓

That are so Significant

↓

That a 3rd party would Reasonably conclude that

↓

Auditor's I, O, PS has been compromised

***Relationship b/w** → **Auditor** / → **Client**

↓

(i) Auditor himself satisfied about his independence

(ii) No unbaised person → would be forced to conclude

↓

Abridgement of Auditor's independence

***Independence → subjective matter**

↓

Dependent upon → **State of mind** / → **Character of person**

Professional integrity and independence are essential characteristics of all the professions but are more so in the case of accountancy profession. 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.

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. 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.

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.

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.

Independence of an auditor assumes significance in context of providing confidence to users of financial statements. 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. 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.

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. 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.

Notes to Add

THREATS TO INDEPENDENCE

Threats to Independence

Self Interest threats	Self Review threat	Advocacy Threat	Familiarity Threat	Intimidation Threat
↓	↓	↓	↓	↓
Financial Interest of Partner/ Associate	Review of any judgements or conclusions reached in previous audit	Auditor promote or perceived to promote a client's opinion	Auditor forms Relationship with client	Auditor is deterred to act objectively

Notes to Add

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

Self-interest threats occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. 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

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. 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. 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

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, e.g., when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes. In such situations, auditor can be perceived as backing and championing causes of auditee client and it may lead to belief that auditor is not acting and working objectively.

4. Familiarity threats

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. 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.

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

Intimidation threats occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. 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. Such threats attempt to intimidate auditors to deter them from acting objectively.

SAFEGUARDS TO INDEPENDENCE

Safeguards to Independence

(*i*) Always be & appear to be Independent

(*ii*) Have I, O, PS

(*iii*) Consider threats to his Independence

(*iv*) Desist from the task or put inplace safeguards

(*v*) If unable to fully implement safeguards → must not accept work

Notes to Add

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.

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.

To address the issue, the following guiding principles are to be applied:

- 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.
- Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
- 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.
- If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Notes to Add

PROFESSIONAL SKEPTICISM

Professional Skepticism (PS) → Attitude involving

- Questioning Mind
- Alert to Conditions → Indicating possible misstatement → Due to F/E
- Critical Assessment of A.E

Examples

- A.E → That contradicts → Other A.E.
- Questionable
  - Reliability of Doc
  - Responses to inquiries
- Possibility of fraud
- Need for Add Audit procedure

*P.S. → reduces risk of
- Overlooking → unusual circums tances
- Over genralising → conclusion
- Using → inappro. asumption

↓

Includes → consideration
- Suff.
- Appro.

A.E.

*Doubt over Reliability of info + Indication of possible Fraud — Further investigation → Determine
- Modification
- Addition

Necessary

*Past Honesty / Intergrity of Mgt. / TCWG — Does not relieve the Auditor → To maintain P.S.

Audit Engagement	And	Terms of Audit Engagement

Audit Engagement → Engaging an Auditor → By a client → For audit of its F.S.

Terms of Audit Engagement → Includes matters
- Objective + Scope → Audit of F.S.
- Responsibilities of
  - Auditor
  - Mgt.
- Identification → App. F.R.F.
- Expected
  - Form
  - Content

  Audit Report

An audit engagement involves engaging an auditor by a client for audit of its financial statements. Audit engagement terms can include matters such as objective and scope of audit of financial statements, responsibilities of auditor, responsibilities of management, identification of applicable financial reporting framework for preparation of financial statements and reference to expected form and contents of report to be issued by auditor.

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.

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.

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.

Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

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. 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. 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.

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.

Notes to Add

Test Your Understanding

3. CA Raman Gupta is offered appointment as auditor of a company. One of his distant uncles held some shares in the same company. Holding of such shares, by a distant relative, is not prohibited under provisions of law nor does it affect his independence. Before he could accept appointment, he received unfortunate news of death of his uncle who had died without any children. He came to know that he was nominee of these shares having substantial value. It landed him in a tricky situation. What should be proper course of action for him?

Ans. When threats to independence 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.

Holding of shares involves financial interest in the company and is in nature of self-interest threat. He has come to hold shares due to nomination made by his distant relative before accepting the appointment. Considering above, he should take steps to eliminate the threat by selling shares immediately before accepting appointment. Holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence.

4. A Chartered accountant receives about 40% of his total audit fees from a single client. Discuss how it could affect independence of Chartered accountant as auditor of this client. What are such types of threats referred to as?

Ans. Undue dependence on fees of a client constitutes a threat as there is fear of losing the client. Such threats are referred to as self-interest threats.

5. CA Murli Madhavan provides accounting and book keeping services to a leading NGO engaged in environmental protection work. He is also offered audit of the accounts of NGO. Identify and discuss what kind of threat to independence may be involved in accepting such an engagement.

Ans. In this case, Chartered Accountant is already rendering accounting and book keeping services to an NGO. If he accepts audit, he would be involved in reviewing own work. Therefore, the same constitutes "self-review" threat.

6. The auditors of a company have only relied upon management representation letter regarding treatment of certain tax matters under appeal by the company. The auditors have not carried out any other audit procedures to justify management's treatment of the said tax matters under appeal in the financial statements. What is lacking on part of auditors in such a situation?

Ans. In the given case, auditors have relied only upon management representation letter regarding treatment of certain tax matters under appeal by the company. No other audit procedures to verify management's treatment of such matters under appeal have been performed by auditors. It shows lack of "professional skepticism" on part of auditors.

Notes to Add

Notes to Add

AGREEING THE TERMS OF AUDIT ENGAGEMENTS

Agreement on Audit Engagement Terms

↓

In writing → as per SA-210 "Agreeing to the Terms of Audit Engagements"

↓

Auditor should agree to the Terms of Audit Engagement → With Mgt./TCWG

↓

to include

↓

Preconditions for an Audit — [Mgt. / TCWG] — Responsibility

*Objective of Auditor — [Accept / Continue] — Audit Engagement → Only when

↓

Basis upon which it is to be performed

↓

Has been Agreed

↓

Through

- Establising → Pre-condition → Present
- Confirming → Common understanding → B/w — [Auditor / Mgt./TCWG]

Notes to Add

SA 210 deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present.

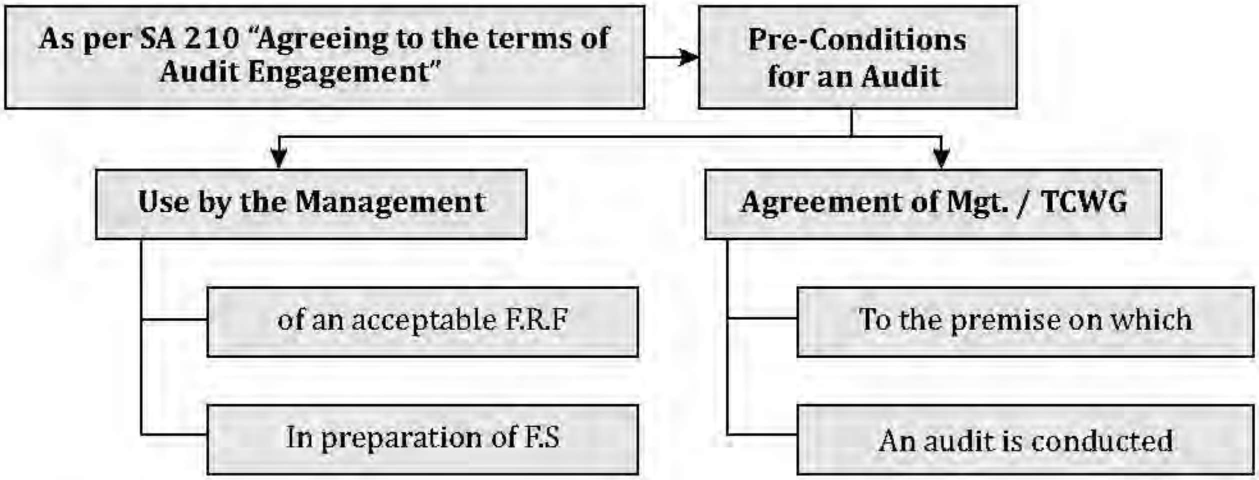
The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

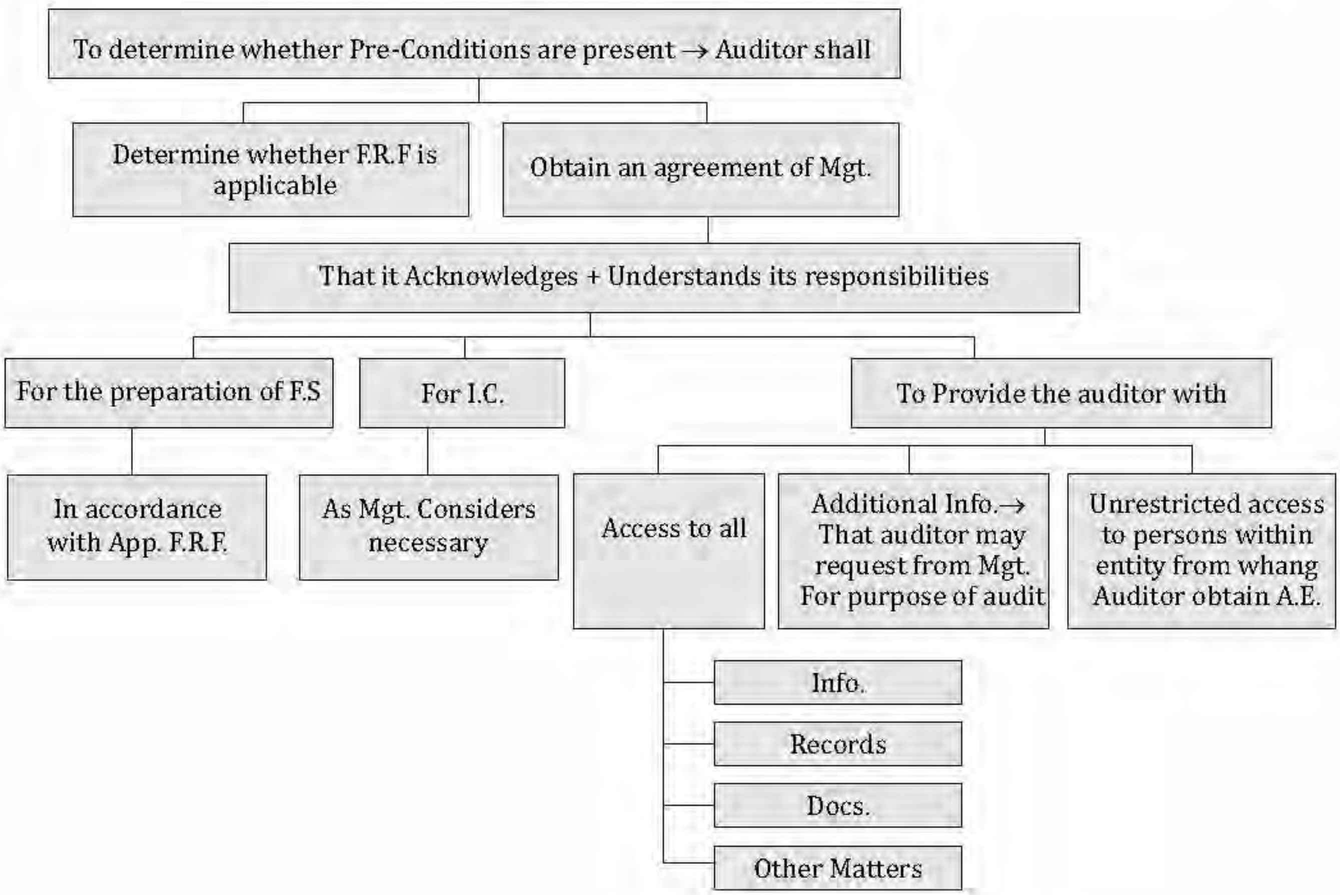
(a) Establishing whether the preconditions for an audit are present and

(b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Notes to Add

PRECONDITIONS FOR AN AUDIT





As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

Notes to Add

Preconditions for an audit

Use by management of an acceptable financial reporting framework → in the preparation of the financial statements → and the agreement of management to the premise on which an audit is conducted

AGREEMENT ON AUDIT ENGAGEMENT TERMS

Scope
↑
Specify   **Writing** → Engagement letter / Other form of written agreement

Audit → contract → B/w → Auditor / Client (Mgt. / TCWG)
↓
Except → Companies → Required under law
↓
To get A/cs Audited

→ Engagement letter → Sent by Auditor → To Client
↓
Possibility of Misunderstanding → Reduced
↓
to include

(i) Objective & Scope → of Auditor
(ii) Responsibilities of Auditor
(iii) Responsibilities of Mgt.
(iv) Identification of app. F.R.F. → for preparation of F.S
(v) Reference of any Expected → Form/Content → of any Report to be issued by the Auditor
+
Statement → that Report may differ from Expected → Form/Content

If → Law → Regulation → Prescribes → Sufficient Details
↓
The Auditor NEED NOT Record them in writing
↓

Except
- Such
  - Law
  - Regulation
  - Applies
- Management
  - Acknowledges
  - Understands
  - Its Responsibilities

In order to establish whether the preconditions for an audit are present, the auditor shall:

(a) Determine whether the financial reporting framework is acceptable and

(b) Obtain the agreement of management that it acknowledges and understands its responsibility:

  (*i*) For the preparation of the financial statements in accordance with the applicable financial reporting framework including where relevant their fair representation;

  (*ii*) For such internal control as management considers necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

  (*iii*) To provide the auditor with:

  - Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
  - Additional information that the auditor may request from management for the purpose of the audit; and
  - Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Except in the cases where it is required under law to get accounts audited (for example in case of companies), audit is a matter of contract between auditor and client. It is, therefore, important, both for the auditor and client, that each party should be clear about the nature of the engagement. It must be reduced to writing and should exactly specify the scope of the work.

The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement.

The audit engagement letter is sent by the auditor to his client. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent. Such a letter includes:-

(a) The objective and scope of the audit of the financial statements

(b) The responsibilities of the auditor

(c) The responsibilities of management

(d) Identification of the applicable financial reporting framework for the preparation of the financial statements and

(e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities.

Notes to Add

EXAMPLE OF AN ENGAGEMENT LETTER

PJ Shrimali & Co. 24, MG Road,

Chartered Accountants Mumbai

10th August XXXX

To the Board of Directors of Pristine Products Limited

The objective and scope of the audit

You have requested that we audit the financial statements of Pristine Products Limited, which comprise the Balance Sheet as at March 31st, 20XX, the Statement of Profit & Loss, Cash Flow Statement for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Standards on Auditing (SAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

The responsibilities of the auditor

We will conduct our audit in accordance with Standards on Auditing (SAs) issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements. As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the company's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

The responsibilities of management

Our audit will be conducted on the basis that management and, where appropriate, those charged with governance acknowledge and understand that they have responsibility:

(a) For the preparation of financial statements that give a true and fair view in accordance with the financial reporting Standards. This includes:
   - The responsibility for the preparation of financial statements on a going concern basis.
   - The responsibility for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards.
   - The responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

(b) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error and

(c) To provide us with:
   (*i*) Access, at all times, to all information, including the books, accounts, vouchers and other records and documentation, of the company, whether kept at the head office of the company or elsewhere, of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters,
   (*ii*) Additional information that we may request from management for the purpose of the audit and
   (*iii*) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the company such information and explanations as we may think necessary for the performance of our duties as auditor. As part of our audit process, we will request from management and, where appropriate, those charged with governance, written confirmation concerning representations made to us in connection with the audit.

Fees

Our fees bill for ₹ XXXXXX (plus applicable taxes) and out of pocket expenses will be raised after completion of audit work.

Reporting

We will report to the members of Pristine Products Limited as a body, whether in our opinion, the financial statements give the information required by the Companies Act, 2013 in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the company as at March 31, 20XX, and its profit/loss, and its cash flows for the year ended on that date. The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

For PJ Shrimali & Co. Chartered Accountants Firm's Registration Number

(Signature)

(Name of the Member)

(Designation)

WHAT HAPPENS IF PRECONDITIONS FOR AN AUDIT ARE NOT PRESENT?

- Discuss matter with Mgt.
  - Auditor determines → F.R.F. Unacceptable
  - Not obtained → Agreement of Mgt.
    - Preparation of F.S.
    - I.C.
    - Access
      - All info.
      - persons
- Not Accept → Proposed engagement
  - Unless
    - Law
    - Regulation

LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE

If Mgt./TCWG → Impose Limitations → On the scope → Such that

↓

Limitation would Result in → Auditor Disclaiming an opinion

↓

The Auditor shall not accept such a limited engagement

Notes to Add

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:

(a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or

(b) If the agreement of management is not obtained on matters relating to understanding of responsibility of management on preparation of financial statements, internal controls for preparation of financial statements, providing access to all information to auditor and unrestricted access to persons within the entity.

Notes to Add

If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Notes to Add

Notes to Add

Acceptance of a change in the terms of the audit engagement

Request from Entity to change the Terms of Audit Engagement-When Reasonable Justification Exists?

REQUEST may Result from

- A Δ in circumstances
- A misunderstanding → As to nature of
  - Audit
  - Related Services
- A restriction on Scope of Engagement
  - Caused by
    - Mgt.
    - Circumstances

Auditor → Carefully Consider

↓

Justification for Request → particularly → Implication of

↓

A restriction on

↓

The scope of Audit engagement

*A Δ in circumstances

↓

affects entity's Requirement

Misunderstanding

↓

Nature of service originally requested

Considered

↓

Reasonable Basis

***Unreasonable Basis → Δ relate to** info

- **incorrect**
- **Incomplete**
- **Unsatisfactory**

What should auditor consider before agreeing to change the audit engagement to the engagement providing lower level of assurance?

Prior Completion of Engagement → Auditor is REQUESTED by client

↓

To change the Engagement → to one which provides

↓

A lower level of Assurance

↓

Auditor should consider the Reasonable justification of doing so

Notes to Add

ACCEPTANCE OF A CHANGE IN THE TERMS OF THE AUDIT ENGAGEMENT

Before Agreeing to Δ → Audit Engagement — Review / Related — Service

↓

Need to assess — Legal / Contractual — Implication

***Auditor concludes → Reasonable Justification**

↓

Δ Audit engagement — Review / Related — Service

+

Audit work → up to the date of Δ → Relevant

+

Work → to be performed / Report → to be issued — Appro. To REVISED **engagement**

*Report → would not include → Reference

- Original Engagement
- Any procedure → that ↓ May have been performed ↑ Original engagement

↓

EXCEPTION

↓

Engagement Δ to under take → Agreed procedure

↓

Reference is Normal part

* Δ Terms of Audit engagement

Auditor / Mgt. — Agree

+

Record

↓

New Terms — Engagement Letter / Other written agreement

Recourse available to auditor in situation of non-agreement to a change in terms of engagement and lack of permission from management to continue original audit engagement.

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

Notes to Add

REQUEST FROM ENTITY TO CHANGE THE TERMS OF AUDIT ENGAGEMENT-WHEN REASONABLE JUSTIFICATION EXISTS?

Auditor → Unable to agree + not permitted to continue to original agreement

Shall | To Δ terms | By Mgt.

- Shall
  - Withdraw from Audit Engagement
    - From where possible under → Law → Regulation
  - Determine whether there is any obligation
    - Contractual
    - Otherwise
    - To Report circumstances to Other Parties
      - TCWG
      - Owners
      - Regulators

For Eg.: अगर आप Company के Auditor हो तब Sec.140(2) के हिसाब से

- Govt.
  - C & AG
  - ROC
  - Co.
- Non Govt.
  - ROC
  - Co. को inform हो करना होगा

Notes to Add

A request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances. The auditor considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

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

In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.

An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

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

Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with SAs may also need to assess any legal or contractual implications of the change.

If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement. However, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:

(a) The original audit engagement or
(b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed- upon procedures and thus reference to the procedures performed is a normal part of the report.

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

RECOURSE AVAILABLE TO AUDITOR IN SITUATION OFNON-AGREEMENT TO A CHANGE IN TERMS OF ENGAGEMENTAND LACK OF PERMISSION FROM MANAGEMENT TO CONTINUE ORIGINAL AUDIT ENGAGEMENT

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

(a) Withdraw from the audit engagement where possible under applicable law or regulation and
(b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

TERMS OF ENGAGEMENT IN RECURRING AUDITS

↓

An Audit → performed → over years

Recurring Audit → Auditor shall assess

Circumstances

Law That require the Terms of Audit Engagement

To be REVISED

Whether there is a need to

REMIND

The Entity

of the existing Terms of Audit Engagements

Notes to Add

Auditor May decide → Not to send → A new → for each period → Audit Engagement Letter → written Agreement

Following Factors makes it appropriate to → Revise → Remind:

(*i*) Any indication that Entity → Misunderstands → Objective → Scope

(*ii*) Any → Revised → Special → Terms of Audit Engagement

(*iii*) A recent Δ in senior Mgt.

(*iv*) A significant Δ in ownership

(*v*) A Significant Δ in → Nature → Size → of Entity Business

(*vi*) A Δ in → Legal → Regulatory → Requirement

(*vii*) A Δ in F.R.F.

(*viii*) A Δ in other Reporting Requirement

Recurring audit is an audit which is performed by an auditor over years. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

(*i*) Any indication that the entity misunderstands the objective and scope of the audit.

(*ii*) Any revised or special terms of the audit engagement.

(*iii*) A recent change of senior management.

(*iv*) A significant change in ownership.

(*v*) A significant change in nature or size of the entity's business.

(*vi*) A change in legal or regulatory requirements.

(*vii*) A change in the financial reporting framework adopted in the preparation of the financial statements.

(*viii*) A change in other reporting requirements.

Notes to Add

Test Your Understanding

7. Chirag, as part of articled training, is part of an engagement team conducting audit of a company. He has read somewhere that engagement letter issued by auditor to client also includes expected form and content of the auditor's report. He was at a loss to understand how could an auditor include form and content of the report beforehand. Try to help Chirag by making things clear to him.

Ans. Engagement letter includes reference to expected form and content of audit report. It merely states that auditor would provide opinion in this form. However, engagement letter also includes statement that the form and content of report may need to be amended in the light of audit findings. Therefore, if in light of audit findings, auditor needs to give a modified opinion, he shall do so.

The management of an entity feels that it is not necessary for it to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. Discuss, whether, it is necessary for the management to do so. In case management refuses, why should an auditor not accept the proposed engagement?

8. It is necessary for management to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. It is a necessary precondition for an audit in accordance with SA 210.

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement: -

(*a*) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or

(*b*) If the agreement of management is not obtained on matters relating to understanding of responsibility of management on preparation of financial statements, internal controls for preparation of financial statements, providing access to all information to auditor and unrestricted access to persons within the entity.

Unless required by law or regulation to do so, such a refusal on the part of auditor is necessary as management is not willing to accept its responsibility for preparation of financial statements in accordance with applicable financial reporting framework. An audit is conducted on this basic premise according to SA 210. When basic premise on which audit is conducted is not fulfilled, refusal by auditor is necessary.

Notes to Add

Notes to Add

AUDIT QUALITY

High Audit Quality → Essential → Maintain Confidence

↓

Independent assurance

↓

Provided by Auditor

Deals with Q.C.

SQC 1	and	SA 220

SQC 1 ↓
- All engagements
  - Audit, Reviews, Assurance, Related — Services
- Entire Firm

SA 220 ↓
- Audit engagements Only
- Particular Audit

SQC 1 –"QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS"

↓

Requires the firm → To establish → Sys. of Q.C.

↓

Designed to provide R.A.

- **Firm** and **Personnel** — **Comply**
  - **Prof. Standards**
  - **Legal** and **Regulatory** — **Requirement**
- **Firm** and **Engagement Partner** — **Reports** ↓ **Appro.**

Notes to Add

The purpose of an independent audit is to provide confidence to users of audited financial statements. Therefore, high audit quality is essential to maintain confidence in the independent assurance provided by the auditors. It is the responsibility of auditor to maintain high audit quality.

SQC 1 and SA 220 both deal with quality control. Whereas SQC 1 deals with all engagements including audits, reviews and other assurance and related service engagements, SA 220 applies to audit engagements only.

Further, SQC 1 applies to entire firm. However, SA 220 applies to a particular audit engagement.

Notes to Add

SQC 1– "Quality Control For Firms That Perform Audits And Reviews Of Historical Financial Information, And Other Assurance And Related Services Engagements"

SQC 1 requires that the firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm or engagement partners are appropriate in the circumstances. Firm's system of quality control should consist of policies designed to achieve these objectives.

Notes to Add

Elements of system of Quality Control

- **Leadership Responisibilities for quality within the firm**
- **Ethical Requirements**
- **Acceptance & Continuance of client's relationships & specific Engagements**
- **Human Resources**
- **Engagement performance**
- **Monitoring**

Q.C. → P & P — Documented / Communicated — To Firm's Personnel

Notes to Add

Notes to Add

ELEMENTS OF SYSTEM OF QUALITY CONTROL

The firm's system of quality control should include policies and procedures addressing each of the following elements: -

(a) Leadership responsibilities for quality within the firm
(b) Ethical requirements
(c) Acceptance & continuance of client relationships & specific engagements
(d) Human resources
(e) Engagement performance
(f) Monitoring

Quality control policies and procedures should be documented and communicated to the firm's personnel. By communicating, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.

Notes to Add

Elements of a System of Quality Control: The firm's system of quality control should include policies & procedures addressing each of the following elements:

Notes to Add

LEADERSHIP RESPONSIBILITIES FOR QUALITY WITHIN THE FIRM

SQC – 1 → Requires Firms → to establish P & P

↓

Designed to promote

↓

Internal culture

↓

Based on recognition → Quality is essential

P & P require → Firm's [CEO / Managing Partner] — Ultimate responsibility

↓

Firm's Sys. Of Q.C.

→ Persons assigned → for firm's Q.C. Sys.

↓

Should have [Suff. / Appro.] — Experience + Ability + Authority

Notes to Add

SQC 1 requires firms to establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to assume ultimate responsibility for the firm's system of quality control. The example set by firm's leadership encourages an inner culture that recognizes high quality audit work. Further, persons assigned operational responsibilities for the firm's quality control system by the firm's chief executive officer or managing partners should have sufficient and appropriate experience, ability and the necessary authority to assume that responsibility.

Notes to Add

ETHICAL REQUIREMENTS

Ethical Requirements

- Integrity
- Objectivity
- Professional Competence + Due Care
- Confidentiality
- Professional Behaviour

As per code of Ethics for professional Accountants

Observance of independence → Basic Req. → All engagements

⇒ Firm should establish P & P → designed to provide it with R.A.

- Firm
- Its personal
- Experts ↓ Contracted
- Network Firm's Personnel

Maintain Independence

\+

- Communicate ↓ Independence requirement ↓ To its personnel
- Identify + Evaluate
  - Circumstances
  - Relationships

  Create ↓ Threat to independence

  \+

  Take Appro. action
  - Eliminate
  - Reduce ↓ Acceptable Level

  ↓ Applying safeguards (Or) ↓ Appro. To withdraw

→ The firm should create a mechanism

- Engagement partners ↓ Provide relevant info ↓ Client engagement
- Firm's personnel ↓ Notify ↓ That create threat
  - Circumstances
  - Relationships
- Breach of independence ↓ Promptly notified
- Written confirmation of compliance ↓ P & P ↓ At least annually

The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements contained in the Code of ethics issued by ICAI.

The Code establishes the fundamental principles of professional ethics which include integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

Observance of "Independence" in all engagements is the basic requirement. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and (including experts contracted by the firm and network firm personnel) maintain independence where required by the Code. Such policies and procedures should enable the firm to: -

(a) Communicate its independence requirements to its personnel.

(b) Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.

There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence. All breaches of independence should be promptly notified to firm for appropriate action. Its objective is to ensure that independence requirements are satisfied.

At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

Notes to Add

ACCEPTANCE AND CONTINUANCE OF CLIENT RELATIONSHIPS AND SPECIFIC ENGAGEMENTS

Firm → Before accepting
- New client
- Continue on existing engagement

→ Acquire vital info.
- Integrity of client
- Competence + Capability + Time + resource → To perform engagement
- Compliance ↓ Ethical Reg.

⇒ Where — Issues identified + Firm decides to — Document issue resolution
- Accept
- Continue → client relationship + Specific engagement

⇒ Matter → Regarding → integrity of client

(1) Identity + Reputation → client's
- Principal Owners
- KMP
- Related Parties
- TCWG

(2) Nature
- Client operation
- Business Practices

(3) Info. → Attitude → client's
- Principal owners
- KMP
- TCWG

  - Aggressive interpretation of AS
  - I.C. Env.

(4) Client → Aggressively concerned → maintaining Low firm's Fees

(5) Indication → Inappro. Limitation → scope of work

(6) Indication → client involved
- Money laundering
- Criminal activities

(7) Reason
- Proposed appointment → of firm
- Non – reappointment → previous firm

⇒ Any → conflict of interest
- Firm
- client

↓

Properly Resolved → Before accepting

A firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about:

- Integrity of Client
- Competence (including capabilities, time & resources) to perform engagement
- Compliance with ethical requirements

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key
- Management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as
- low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

If there is any conflict of interest between the firm and client, it should be properly resolved before accepting the engagement. Where the firm obtains information that would have caused it to decline an engagement if that information had been obtainable earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:

(a) The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and

(b) The possibility of withdrawing from the engagement or from both the engagement and the client relationship.

Notes to Add

⇒ Firm obtains Info. → would have caused to decline

↓

If info. had been obtained earlier

↓

P & P should include consideration of

- Prof. + Legal Resp.
- Req. of Firm ↓ To report
  - Person (s) ↓ Who made appointment
  - Regulatory Authorities
- Possibility of withdrawing
  - Engagement
  - Engagement + Client Relationship

HUMAN RESOURCES

Firm should establish P & P → Designed to provide it with R.A.

↓

That it has suff. Personnel with

- **Capabilities**
- **Competence**
- **Commitment ↓ To ethical principles**

To perform in accordance with + Issue Appro. Report

- **Prof. Standard**
- **Legal Requirement**
- **Regulatory Requirement**

Notes to Add

Notes to Add

The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances. Such policies and procedures should address relevant HR issues including recruitment, compensation, training, career development, performance evaluation etc. There should be emphasis on the continuing professional development of firm's personnel.

Notes to Add

ENGAGEMENT PERFORMANCE

(1) Consistency in quality → through briefing of team

- Objectives
- Process for Complying
- Engagement
  - Supervision
  - Training
- Reviewing Performance
- Appro. Documentation

(2) Consultation — Difficult / Contentious — Matters

↓

Discussion → Individual (s) — Within / Outside — Firm

(3) Sig. Judgement → Reviewed by → Q.C. Review

→ Firm should establish P & P

↓

To complete the assembly of Final Engagement File

↓

On Timely Basis → Generally ≤ 60 Days

↓

After the date of Auditor Report

→ Engagement Doc → Retained → Suff. Time pd.

↓

No shorter than 7 years

Notes to Add

ENGAGEMENT PERFORMANCE

Consistency in quality of engagement performance is achieved through briefing of engagement teams of their objectives, processes for complying with engagement standards, processes of engagement supervision and training, methods of reviewing performance of work, appropriate documentation of work performed.

Consultation should take place in difficult or contentious matters pertaining to an engagement. Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter.

A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by other firms or professional and regulatory bodies.

Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer for taking an objective view before the report is issued. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

Engagement quality control review is mandatory for all audits of financial statements of listed entities. In respect of other engagements, firm should devise criteria to determine cases requiring performance of engagement quality control review.

There might be difference of opinion within engagement team, with those consulted and between engagement partner and engagement quality control reviewer. The report should only be issued after resolution of such differences. In case, recommendations of engagement quality control reviewer are not accepted by engagement partner and matter is not resolved to reviewer's satisfaction, the matter should be resolved by following established procedures of firm like by consulting with another practitioner or firm, or a professional or regulatory body.

Besides, the firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. The assembly of engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements and in other cases within the limits appropriate to engagements.

Policies and procedures should be designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.

Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

Engagement documentation has to be retained for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

In the specific case of audit engagements, the retention period ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

MONITORING

Firm should ensure that P & P → Related to Sys. Of Q.C.

- Relevant
- Adequate
- Operating effectively
- Complied with
  ↓
  In practice

SA 220-"QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS"

statements"

***Based on Q.C. Sys. Of a firm**

↓

Q.C. policies pertaining to Audit engagements are decided by engagement teams

***Engagement partner → Responsible for Q.C. → as per SA 220**

***As per SA 220 → Objective of Auditor → implement Q.C. policies**

↓

Provide him with R.A.

- **Audit complies with**
  - **Prof. Standards**
  - **Legal**
  - **Regulatory**

  Legal and **Regulatory** — **Requirement**
- **Issue Appro.**
  ↓
  Audit Report

SA 220 → modelled → on lines of SQC.1

- Leadership Responsibilities for quality within the firm
- Ethical Requirements
- Acceptance & Continuance of client's relationships & specific Engagements
- Human Resources
- Engagement performance
- Monitoring

Notes to Add

The firm should ensure that policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

Notes to Add

LEADERSHIP RESPONSIBILITIES FOR QUALITY ON AUDITS

Leadership Responsibilities for quality within the firm on Audit

- As per SA 220 "Quality control for an Audit of F.S"
  ↓
  Engagement partner shall take responsibility
  ↓
  for overall quality of each audit engagement → to which he is assigned.

- Engagement partner's Actions **+** Messages to Engagement Team Members

Should emphasize

Importance of Audit Quality of

Quality Is essential in performing audit engagement

Importance of Audit Quality of

Performing work that complies with

Comply with firms Q.C. policies

Issuing appropriate Audit Report

Team's ability to raise concerns without fear

Professional standards

Legal

Regulatory

Requirements

Notes to Add

Based upon quality control system of firm, quality control policies pertaining to audit engagements are decided by engagement teams. Engagement partner of a team is responsible for quality control procedures of a particular audit engagement in accordance with SA 220.

Therefore, SA 220 is premised on the basis that the firm is subject to SQC 1. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

As per SA 220, the objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that: -

(a) The audit complies with professional standards and regulatory and legal requirements and

(b) The auditor's report issued is appropriate in the circumstances.

SA 220 is modelled on lines of SQC 1. It describes responsibilities of engagement partner in relation to following matters:

(a) Leadership responsibilities for quality on audits

(b) Relevant ethical requirements

(c) Acceptance and continuance of client relationships and audit engagements

(d) Assignment of engagement teams

(e) Engagement performance

(f) Monitoring

Leadership responsibility of an engagement partner is to take responsibility for the overall quality on each audit engagement. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise

(a) The importance to audit quality of:

   (*i*) Performing work that complies with professional standards and regulatory and legal requirements;

   (*ii*) Complying with the firm's quality control policies and procedures as applicable;

   (*iii*) Issuing auditor's reports that are appropriate in the circumstances; and

   (*iv*) The engagement team's ability to raise concerns without fear of reprisals.

(b) The fact that quality is essential in performing audit engagements.

Notes to Add

RELEVANT ETHICAL REQUIREMENTS

Relevant ethical requirements

- **Identify** ↓ **Threat to independence** ↓ **Safeguard may not be able to**
  - Eliminate
  - **Reduce to an Acceptably low level**
- **Reporting → Engagement partner** ↓ **To Relevant Person** ↓ **Within the firm** ↓ **To determine appro. action**
  - **Eliminating the activity/interest**
  - **Withdrawing** ↓ **Where legally permitted**

Acceptance and Continuance of Client Relationships and audit Engagements

SQC-1 → Requires the firm → to obtain info ← Before Accepting Audit Engagement

- Integrity of Principal owners, KMP & TCWG of entity
- Competence of Engagement Team + Time & Resources
- Firms' Engagement Partner
  - Comply with ethical requirements
- Significant matters of current / previous Audit Engagement

Notes to Add

The responsibilities of an engagement partner in relation to ethical requirements in an audit engagement are as under: -

- Identifying a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level.
- Reporting by engagement partner to the relevant persons within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

Notes to Add

ACCEPTANCE AND CONTINUANCE OF CLIENT RELATIONSHIPS AND AUDIT ENGAGEMENTS

The responsibility of an engagement partner in this regard in an audit engagement is on lines of SQC 1 which requires the firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

Information like integrity of principal owners, competence of engagement team and consideration of necessary capabilities including time and resources, compliance with relevant ethical requirements and significant matters arisen during current or previous audit engagement and their implications assist the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate.

Notes to Add

ASSIGNMENT OF ENGAGEMENT TEAMS

It should be ensured — Engagement Team / Auditor's expert — collectively

↓

Who are not a part of team

Competent — Capable

To perform engagement as per

Prof. Standards — Legal — Regulatory

Requirements

ENGAGEMENT PERFORMANCE

Responsibilities of engagement partner

(1) Direction / Supervision / Performance — Audit → as per — Prof. Standard / Legal / Regulatory — Requirement

(2) Appro. Audit Report

(3) Review→Audit Doc→ Before → Issue of Audit Report

(4) Ensure → Suff. + Appro.→ A.E.→ Obtained

(5) Undertaking→Appro.Consultation— Difficult / Contentious — Matters

(6) For→listed entities + where Q.C. Reviewer Required

- Determine ↓ Q.C. Reviewer Appointed?
- Discuss ↓ Sig. Matters
- Until completion of Q.C. Review ↓ Not to date the Auditor's Report

→ If Difference of opinion arise → Engagement team

↓

Follow

↓

Firm's P & P for — Dealing / Resolving — Differences

It should be ensured by engagement partner that the engagement team and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the engagement in accordance with professional standards and regulatory and legal requirements.

Notes to Add

Engagement partner has the responsibility for direction, supervision and performance of audit engagement in accordance with professional standards and regulatory and legal requirements. He is responsible for auditor's report being appropriate in circumstances. Further, review of audit documentation before issue of audit report is his responsibility. It has to be ensured that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for issuance of auditor's report.

Engagement partner is also responsible for ensuring undertaking appropriate consultation on difficult or contentious matters by engagement team not only within the team but also with others at appropriate level within or outside the firm.

For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

(a) Determine that an engagement quality control reviewer has been appointed.

(b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer.

(c) Not date the auditor's report until the completion of the engagement quality control review.

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

Notes to Add

MONITORING

Monitoring

Firm should → P&P → design to provide it with R.A →that P & P relating to → System of Q.C

- Relevant
- Adequate
- Operating Effectively
- Complied with → In practice

Engagement Partner → Document

- Issues ↓ Identified w.r.t. ↓ Compliance with ethical Req. + How they were Resolved
- Conclusions ↓ On compliance + Relevant Discussions
- Conclusions ↓ Acceptance + Continuance of client Relationship
- Nature + Scope + Conclusion ↓ Consulation

Notes to Add

An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

The engagement partner should document following matters pertaining to an audit engagement: -

(*a*) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.

(*b*) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

(*c*) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.

(*d*) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.

Notes to Add

SUMMARY NOTES OF SQC-1 & SA 220

Basic	SQC 1	SA 220
Applicable	All engagement Audit Assurance Review Related Engagements	Audit Engagement
Applies	Firms	Audit
Leadership Responsibility for Quality	CEO + Managing Partner Ultimate Resp. + Encourages → Inner Culture → Q.C. Sys. + Persons Assigned Experience Ability Authority	Engagement Partner ↓ Overall Resp. + Eng. Partner Actions Messages → Team Emphasis → Quality Importance Essential → Quality → Importance ↓ (1) Complies Prof. Legal Regulatory (2) Comply → Firm → Q.C. P & P (3) Issue → Appro. Report (4) Team's ability to raise concern without lear
Ethical Req.	Code of Ethics → Issued by ICAI Integrity Prof. Competence + Due Care Prof. Behavior Objectivity Confidentiality + Independence — Firms Personal Experts Network Firms Personal	

Basic	SQC 1	SA 220
Ethical Req.	Independence Communicate ↓ Personnel Identify + Evaluate Circumstances → Threat to Independence ← Relations Eliminate / Reduce Law Level Appro. Action / Safeguard / Withdraw (1) Mechanism → Relevant Info. (2) Promptly Notify → Threats (3) At least annually → Written Confirmation ↑ Independence	Same

Basis	SQC 1	SA 220
Acceptance & Continuance of Engagement	Before accepting Engagement ↓ Obtain info. → Client Integrity · Competence + Capability + Time + Resources · Confidentiality ↓ Ethical Reg. Issues → Identified ↓ Document → How they were Resolved ⇒ Examples → Integrity of Client (1) Principal Owners + Related Parties + KMP + TCWG Identify · Business Reputation (2) Nature Client Operations · Business Practices Principal Owners + KMP + TCWG (3) Attitude ↓ Aggressive Interpretation of AS	Same

Basic	SQC 1	SA 220
Acceptance & Continuance of Engagement	(4) Aggressively Concerned ↓ Maintaining ↓ Firms Fees → Low (5) In appro. Limitation → Scope (6) Involvement – Money Laundering / Criminal Activities (7) Reason – Appointment → Current Firms / Non-Reappoint → Previous Firms → Conflict of Internet Firm – Client Before Accepting ↓ Properly Resolve After Accepting Prof. + Legal Resp. ↓ Report Persons – Persons who made appointment – Regulatory Withdrawal Client – Relation	
Human Resources	Suff. Personnel Capable – Competence – Committed Committed ↓ Ethical Principles + Perform Engagement Prof. Standards – Legal Regulatory Legal Regulatory ↓ Requirement + Issue → Appro. Report	Same

Basic	SQC 1	SA 220
Engagement Performance	Quality → Consistent ↓ Briefing Engagement ↓ (1) Objective (2) Process – Complying → Standards; Supervision; Training (3) Performance Review → Method (4) Document → Work Performed ⇒ Consultation → Prof. Level Difficult, Contentious → Matters Within, Outside → Entity ↓ With Expertise ⇒ Sig. Judgement → Review → Q.C. Reviewer ⇒ Extent of Review – Complexity; Risk ⇒ Review → Does Not Reduce ↓ Engagement Partner ⇒ Q.C. Review Listed Entities ↑ Mandatory Other Entities ↑ Device Criteria ⇒ Q.C. Report → To be issued ↓ Only After → Resolution of Diff. Eng. Team; Those Consulted; Eng. Partner; Q.C. Reviewer ⇒ Q.C. Reviewer → Recommendation ↓ Not Accepted + Matter → Not Resolved Consult Another Practitioner; Firm; Professional; Regulatory	Engagement Partner Responsibilities Listed Entity; Other Engagement (1) Appoint → Q.C. Reviewer (2) Sig. Matter → Discuss (3) Date → Auditor Report ↓ After → Q.C. Review

Basic	SQC 1	SA 220
Engagement Performance	⇒ Completion of Final Assembly ≤ 60 days → AFTER → Auditor's Report ≤ Limits of Engagement ⇒ Engagement Documentation ↓ PROPERTY OF FIRM ↑ Unless Specified – Law / Regulation ⇒ Firm → May make available Portion / Extracts → Documentation ← ↓ To Client ↑ Provided ↓ Does not undermine Validity of Work Performed Independence – Firm / Personnel ⇒ Retention Period ↑ Documentation Other Engagement → Period of Time – For Monitoring Procedures – Longer → Reg. – Law / Reg. Audit Engagement → > 7 Years → Date of – Audit Report – Group Audit Report	

Basic	SQC 1	SA 220
Monitoring	⇒ P & P Relevant, Adequate, Operating Effectively, Complied ↓ In Practice	⇒ Document (1) Issues – Identified / Resolved ↑ Ethical Reg. (2) Conclusions / Discussions – Independence (3) Conclusion → Acceptance + Continuance → Client Relation (4) Nature / Scope / Conclusion – Audit

Test Your Understanding

9. CA PK Nair is offered appointment as auditor of a company engaged in providing tourism services. While making due diligence of the proposed client, he comes to know that there have been raids on premises of the company and residences of its directors by National Investigation Agency (NIA) on suspicion of links with terror outfits. It has been followed up with searches by Enforcement Directorate hunting for illicit money trail. There is a strong suspicion of tourism services provided by company being façade of terror funds. Should proposed offer be accepted by him?

Ans. Integrity of principal owners has to be considered before accepting an audit engagement in accordance with SA 220. In this regard, SA 220 states requirements on lines of SQC 1. SQC 1 clearly states that in cases where there are indications that the client might be involved in money laundering or other criminal activities, appointment should not be accepted.

In the instant case, there have been raids of NIA on suspected links with terror outfits which is a criminal activity. Further, raids by Enforcement Directorate also point towards money laundering. Therefore, proposed offer should not be accepted.

10. CA Arpita has joined a mid-sized CA firm recently. She finds that partners remain too busy and the firm is proposing to accept audit work in areas in which it has no experience or capabilities. The firm is proposing to accept audit of some entities engaged in emerging "fin-tech" sector. Such audits may be requiring extensive use of technology and data analytics. However, the said firm has no such capabilities and trained personnel. Discuss, whether, firm should accept such audits with reason.

Ans. SQC 1 requires that before accepting an engagement, competence (including capabilities, time and resources) to perform engagement have to be considered.

In the given case, the proposed engagements involve use of technology and data analytics. The firm has no prior experience of audits in emerging "fin- tech" sector. The firm does not have trained personnel to carry out these audits. Hence, offer for these audits should not be accepted.

CASE STUDY

Das & Co, a firm of auditors, is offered appointment as auditor of a company, a prospective new client. CA Sukanya, one of partners, is dealing with new client. While meeting with officers of the company, she comes to know that Sushant, CFO of the company, was her class mate. In fact, both of them had started CA together. However, Sushant had left CA mid-way due to repeated failures and tried his luck to pursue MBA (finance) from one of leading institutions.

During initial discussions, it transpires that company is going to launch new services in the field of "weather-forecasting". Such services would be available on web site of company and micro weather information would be available on payment of charges. The company requests audit firm to be visibly associated with their marketing blitz.

Assume that firm choses to accept the offer and writes to previous auditor, Walker & Co., to advise whether there exist any professional reasons for them not to accept the proposed offer. However, Walker & Co. do not reply to the request of Das & Co.

During preliminary discussions, it also became known that the said company has acquired all shares of another company. Under relevant provisions of law, financial statements of both companies needed to be consolidated and audited. Despite this knowledge, Das & Co. failed to advise their client regarding audit of consolidated financial statements.

The company also offers auditors contract for providing IT services pertaining to information system of company.

QUESTIONS

Based on above, answer following questions:

1. Considering discussion about Sukanya and Sushant, which of the following statements seems most appropriate?
   (*a*) The above discussion is irrelevant in context of proposed offer.
   (*b*) The proposed offer should be accepted by firm. The engagement team may be headed by CA Sukanya for better coordination and results.
   (*c*) The proposed offer should be accepted by firm. The engagement team may be headed by a different partner of the firm.
   (*d*) The matter is too trivial to be reported by CA Sukanya to other partners of firm.

Ans. (*c*)

2. Keeping in view request of the company to be visibly associated with company's new services, identify which type of threat is being faced by audit firm.
   (*a*) Self-interest threat (*b*) Familiarity threat
   (*c*) Self-review threat (*d*) Advocacy threat

Ans. (*d*)

3. The previous auditors, Walker & Co., have not replied to communication of Das & Co. Which fundamental principle of professional ethics is not followed by them?

(*a*) Objectivity
(*b*) Professional behaviour
(*c*) Professional competence and due care
(*d*) Integrity

Ans. (*b*)

4. Das & Co. have failed to advise the company regarding audit of consolidated financial statements. Which fundamental principle of professional ethics is violated by Das & Co.?

(*a*) Professional behaviour
(*b*) Integrity
(*c*) Objectivity
(*d*) Professional competence and due care

Ans. (*d*)

5. Which of the following statements is most appropriate regarding providing offer of work of IT services by auditors to the company?

(*a*) Such offer may create a self-review threat
(*b*) Such offer may create an advocacy threat
(*c*) Such offer does not constitute any threat
(*d*) Such offer may create self-review and advocacy threats

Ans. (*a*)

Multiple Choice Questions (MCQ)

1. Identify the most appropriate statement: -

(*a*) SA 220 applies at the level of firm.
(*b*) SQC 1 is premised on the basis that firm is subject to SA 220.
(*c*) SA 220 is premised on the basis that firm is subject to SQC 1.
(*d*) SA 220 applies to all engagements.

Ans. (*c*)

2. Professional skepticism includes-

(*a*) Overlooking unusual circumstances
(*b*) Using inappropriate assumptions in determining extent of audit procedures
(*c*) Over generalising when drawing conclusions from audit observations
(*d*) Being vigilant to conditions that might indicate possibilities of fraud

Ans. (*d*)

3. Which of the following is not a fundamental principle governing professional ethics?

(*a*) Professional competence and due care
(*b*) Integrity
(*c*) Objectivity
(*d*) Safeguards to independence

Ans. (*d*)

4. Which of the following is not necessary to establish preconditions for an audit?
   (*a*) Acceptability of financial reporting framework.
   (*b*) Acknowledgment of cooperation from management in designing audit procedures.
   (*c*) Acknowledgment from management of providing access to persons within company.
   (*d*) Acknowledgment of management in understanding its responsibility for preparation of financial statements.

Ans. (*b*)

5. Identify the most appropriate statement in context of SQC 1.
   (*a*) Assembly of engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements.
   (*b*) Engagement files should be completed before date of auditor's report in case of audit engagements.
   (*c*) Engagement files should be completed in not more than 60 days after completion of an engagement.
   (*d*) Engagement files should be completed on date on which audit report is signed in case of audit engagements.

Ans. (*a*)

Correct /Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

6. The audit engagement letter is sent by the client to auditor.

Ans. (Incorrect)

As per SA 210 "Agreeing the Terms of Audit Engagements", the Audit engagement letter is sent by the auditor to his client.

7. The Audit Engagement documentations should ordinarily be retained by the auditor for minimum of six years from the date of the auditor's report or the date of the group auditor's report, whichever is later.

Ans. (Incorrect)

SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

8. Briefly outline how principles-based approach differs from rules-based approach to ethics.

Ans. Refer to topic on principles-based approach vs. rules- based approach to ethics.

Theory Questions

9. How application of professional skepticism throughout audit is helpful in reducing audit risk?

Ans. Refer to topic on "Professional Skepticism".

10. A Chartered accountant is conducting audit of a client for last two years. Before proceeding to start audit for next year, he notices that there is substantial change in management. Besides, client has ventured into areas of business activity which were not present at time of accepting initial audit engagement. Discuss responsibility of auditor in this regard in context of SA 210.

Ans. Refer to heading "terms of engagement in recurring audits".

11. How does SQC 1 ensure that independence in engagements is not breached by an audit firm?

Ans. Refer to heading of Ethical requirements under "Elements of System of quality control" in SQC 1.

12. An engagement partner takes overall responsibility for maintaining audit quality in an audit engagement in accordance with SA 220. What are his objectives in taking and emphasizing such responsibility?

Ans. Refer to heading of "Leadership responsibilities for quality on audits" under SA 220.

❑❑❑

Notes to Add

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About The Author

Ankit Mundra is a faculty member of Auditing & Assurance at Physics Wallah. He has been teaching for over 12 years and has a passion for helping students learn and grow. In addition to his work as a teacher, Ankit is also engaged as an entrepreneur, corporate lawyer, and GST practitioner. In the past, he has worked as a forensic auditor for various MNCs, a professor at various reputed colleges, and has also been engaged with ICAI and the Ministry of Corporate Affairs. Ankit is a dedicated educator and a talented author. He is passionate about students learning and his methods of teaching via charts, stories, and real-life examples are loved by his students. Till now, he has taught more than 100,000 students both offline and online.

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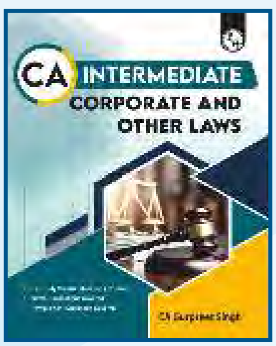

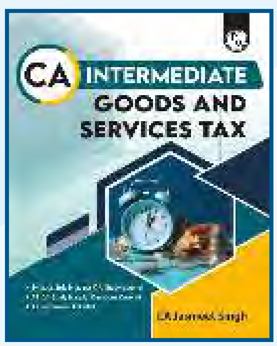

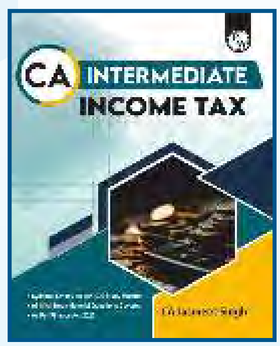

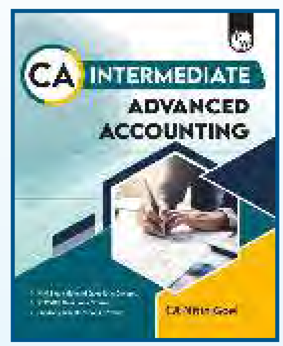

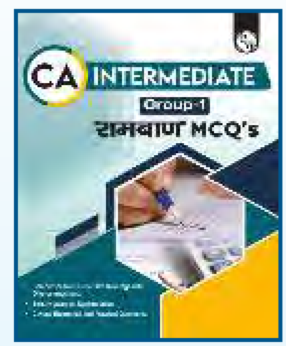

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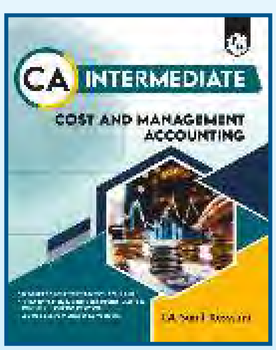

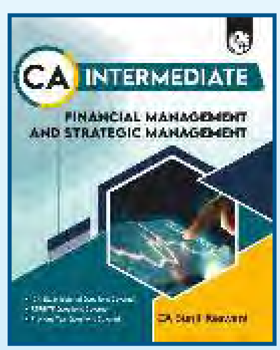

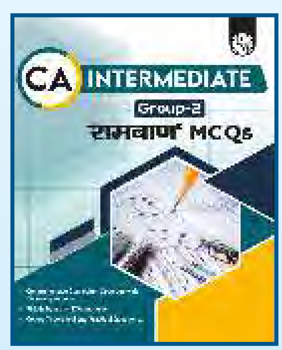

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