M.Com. PART - II

Paper - IV

ADVANCED AUDITING

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PATTERN OF QUESTION PAPER

Maximum Marks : 100 **Duration : 3 Hours**

Number of questions to be asked	09
Number of questions to be answered	06
Question No.01 (Compulsory Question)	20 Marks
Question No.02 (Compulsory Objective)	16 Marks
Question No. 03 to Question No. 09 (Any 4)	16 Marks each

Notes:-

(1) From Question No. 03 to Question No.09 not more than one question may be theory including short problems/questions.

(2) Student to answer any four out of Question No. 03 to Question No.09 .

(3) Objective questions to be based on all topics and include Inter alia questions like :-

(a) Multiple choice (b) Fill in the blanks

(c) Match the columns (d) True or False

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1

AUDIT OF LEDGERS

Unit Structure

1.0 OBJECTIVES

After studying the unit the students will be able:

- To Provide Classified Financial Information
- To Provide Check On Arithmetical Accuracy
- To Help Ascertain Profit Or Loss
- To Help Study The Financial Position

1.1 STEPS INVOLVED IN THE AUDIT OF LEDGERS

The audit of ledgers normally involves the following steps:

(i) Internal check - Test the quality of internal check-regarding timely and correct entries in the ledger.

(ii) Opening balances - Trace the opening balances from previous year's audited balance sheet. In case, the entity is getting its accounts audited for the first time since inception or it was audited in previous year by some other auditor, follow the procedures given in SA 510 "Initial Engagements - Opening Balances "issued by ICAI.

(iii) Postings - Check postings from cash book and other books of prime entry (i.e., purchases book, sales book, journal, purchase returns book, sales return book, bills receivable book, bill payable book).

(iv) Control accounts - Total up the balances in the subsidiary ledgers. Tally the totals with those in the control accounts.

(v) Verification of personal account balances - Verify personal account balances with statements of account received from the parties or by arranging direct confirmation. The procedure of direct confirmation should be applied in the manner stated in SA 505 External Confirmations issued by ICAI.

(vi) Verification of Real accounts - The real account balances should be verified by

- physical verification (as in the case of cash and investments),
- checking the working papers of physical verification exercise conducted by the management (as in the case of fixed assets and inventories),
- inspection of documents (as in the case of intangible assets such as patents and trade marks), and
- direct confirmation (as in the case of stocks lying with third parties).

(vii) Scrutiny of individual accounts - Scrutinize individual accounts. Examine the composition of balances. Examine age analysis of various items outstanding.

(viii) Totals - Check totals of ledger accounts, schedules of balances, groupings etc.

(ix) Tracing into the final accounts - Trace the balances in individual accounts on to the schedules, from thereon into the groupings-and from the groupings into the final accounts.

(x) Analytical Review - Examine the reasonability of balances by applying analytical procedures e.g. comparison with opening balances, debtors turnover ratio, creditors turnover ratio, current ratio, fixed assets turnover ratio, working capital turnover ratio etc.

1.2 AUDIT OF BOUGHT LEDGER

Following is the procedure to the audit the Bought Ledger (Creditor's Ledger)

Audit of bought ledger should be taken up only after vouching of Purchase Journal, Purchase Returns Journal, Cash Book and Journal and verification of Bank Reconciliation Statement have been completed and all the queries arising from these have been satisfactorily resolved. The steps in audit of bought ledger are generally the following:

(a) Opening balances - Check the opening balances of all suppliers accounts from the last year's audited schedule.

(b) Postings - Check the postings from the books of prime entry (i.e., purchase journal, purchase returns journal, cash book, bills payable book, main journal).

(c) Totals - Check the totals of individual accounts of suppliers.

(d) Agreement with control account - The total of balances of the individual suppliers' accounts agree this total with the control account of sundry creditors in the general ledger.

(e) Debit balances-

♦ Pay special attention to debit balances in suppliers' accounts. Enquire into the reasons for such debit balances. These may be advances against which supplies are yet to be received or they may represent advances not adjusted against billing. Another possibility could be that the payment to the supplier has been posted to his debit but the entry for purchases (i.e., by debiting purchases and crediting his account) has been omitted.

♦ Scrutinize advances against which deliveries are pending for long time. See that these are genuine advances and not merely financial accommodation of a favoured party. Whether the advance is a genuine one or merely for financial accommodation should be judged keeping in mind factors such as :

- the value of purchases;
- the proportion of value of purchases given as advance;
- the normal lead time for delivery;
- the normal trade practices; and
- whether the party is a sister concern.

These debit balances should not be netted off from credit balances but shown separately on **Assets** side of the Balance Sheet.

(f) Composition of balances - Scrutinize the composition of balances by matching each credit (for supplies) with the corresponding debit entry (for payment of bills). The unmatched items should be enquired. If not, there may be cases where the opening balances or earlier credits are unpaid but the later ones are paid. This may reveal any of the following possibilities:—

(i) Remittances to creditors misappropriated.
(ii) Disputes regarding previous balances.
(iii) Liability regarding the amount no longer exists.
(iv) Fictitious liability created to suppress profits.
(v) Payment entry omitted from the books.

(g) Direct confirmation - The auditor should apply direct confirmation procedures for creditors balances (at least a sample of them) in the manner stipulated in SA 505.

(h) Tracing into the final accounts - Trace the balances from the ledger accounts into the schedule of creditors and from thereon to the groupings and then on to the final account

1.3 AUDIT OF SALES LEDGER

Following is the procedure for conducting the Audit of Sales Ledger (Customer's Ledger)

The audit of the sales ledger (customer's ledger) should be taken up only after the books of prime entry **i.e.,** sales day book, sales return book, main journal and cash book have been vouched, Bank Reconciliation Statement has been examined and queries arising out of vouching and examination of BRS have been satisfactorily resolved. The following steps will be generally required in the audit of sales ledger:

(a) Opening balances - Check the opening balances with the audited balance sheet of last year.

(b) Postings - Check the postings from sales day book, sales return journal, credit notes register, debit notes register, main journal and bills receivable book.

(c) Totals - Check totals **i.e.,** castings of accounts of individual customers.

(d) Agreement with control accounts - Check the total of balances of individual customers account. Tally this total with the control account in the general ledger.

(e) Credit balances - Pay special attention to credit balances. It may be such that money has been received in advance from a customer or that the sales entry (debiting customer and creditors: sales) must have been omitted.

(f) Composition of balances - Match each debit for sales to customer with corresponding collection on the credit side. Many customers (particularly big companies) send the remittance advices showing the invoices against which payments have been made. Refer to these while matching the payments against the respective invoices. Unmatched items should be followed up with management for explanations. Observe the patterns and enquire about any change in it. For example, a customer who was making payments in full in one stroke is now making part payments. This may reflect that the customer is having financial difficulties or that teeming and lading is being practiced.

(g) Long outstanding balances - This has been listed as a fraud risk factor by SA 240. This could mean any of the following possibilities :

♦ Bad debts requiring write-offs.
♦ Fictitious sales booked in previous year to bolster profits.
♦ Misappropriation of collections.
♦ Omission of postings for collections.
♦ In case of closely-held companies or firms, the money has been paid to proprietor, partner or director who has deposited it in his personal account.

(h) Foreign currency debtor balances - See that these are stated in the balance sheet by converting the foreign currency receivable into rupees by applying the closing rate (i.e., exchange rate on balance sheet date). The differences arising i.e. exchange differences should be adjusted in Profit and Loss Account as per AS-11.

(i) Subsequent Collections - Verify the genuineness of the debtor balances by checking whether they have been collected in the following period.

(j) Direct confirmations - Obtain direct confirmations of debtor balances by sending out confirmation requests in the manner stipulated in AAS-30 External confirmations.

(k) Tracing into the final accounts - Trace the debtors balances into the schedules of balances from thereon into groupings, from there into final accounts.

(l) Credit card receivables - In case company accepts payment by credit cards, check reconciliation of receivables as per books with credit card company's statements.

1.4 GENERAL LEDGER

The General Ledger contains individual accounts of assets, liabilities, income and expenses. Let us study (a) Why scrutiny of general ledger is done (b) What is done before such scrutiny (c) how scrutiny of general ledger is done.

- **Why Scrutiny is Done**

The objective of the scrutiny of general ledger is to obtain audit evidence in the following matters.

Actual Expenses: The assets and liabilities shown in the general ledger actually exist at the year end. The transactions giving rise to income and expenses recorded in the general ledger actually occurred.

a) Complete Record: The general ledger records all the assets legally owned by the concern at the year – end; all the liabilities legally payable by the concern at the year – end; all the income earned by the concern during the year; and all the expenses incurred by the concern during the year.

b) Value: The closing balances of assets and liabilities are properly valued. The transactions giving rise to income and expenses have been recorded at the proper amounts.

c) Disclosure: The closing balances of assets and liabilities are properly classified and disclosed in the balance sheet. The amounts of income and expenses are properly disclosed in the profit and loss account.

- **What is done before scrutiny**

Before making a scrutiny of General Ledger, auditor should ensure that the following audit procedures have been duly completed:

a) **Study of Internal Control:** Auditor should have studied and evaluated the accounting system and internal audit

b) **Vouching of Transaction:** Then, based on the results of the above study, the auditor should have vouched the transactions which occurred during the year.

- **How Scrutiny is done**

Audit of general ledger involves the following:

1. Checking opening Balances.
2. Checking posting from Registers, Books and Journals.
3. Checking Castings and Totals of the ledger Accounts.
4. Scrutiny of Ledger Accounts.
5. Checking Summary and Groupings.

These steps are explained in detail below.

1. Checking opening Balances

Opening Balances of the General Ledger should be verified with reference to the audited accounts, the General Ledger and the schedule of balance for the previous year.

a) In vouching, auditor checks the entry in the original books such as Cash Book, Sales register, Bills Receivable Register, Purchase Register, Bills Payable Register, Debit Note/ Credit Note Register, Journal etc. The next step is to check the postings from these books into the General Ledger. Auditor should check that the correct amount is posted in the correct account on the correct side of the account.

b) Posting may be checked on sample basis. Auditor may check either all the postings for say 3 months or check posting into selected accounts for the whole year.

c) The following aspects should be checked –

- **i.** All entries are posted as per the dates i.e. in chronological order.
- **ii.** No entry is inserted in between two entries afterwards.
- **iii.** No entry is altered.
- **iv.** Against each entry, there is reference of the folio of the original book or register.

2. Checking Casting

Auditor should check the totals of the ledger accounts. If an account runs into many pages, he should check that the total of one page is correctly carried forward to the next page.

3. Scrutiny of Ledger Accounts

General Ledger contains accounts of Income, Expenses, Assets or Liabilities. The scrutiny of Income and Expenses Accounts is described below.

A. Sales Account

I. **In-depth Checking:** Sales Account being the main source of income is scrutinized in depth. The monthly summary is checked from the Sales Register Debit / Credit Note Register. Posting from cash / bank / journal are individual and not summary postings. These are checked on sample basis.

II. **Cross – Checking:** Sales amount is cross – checked with figures of sales in the Sales Tax Returns, Excise Registers, Returns with Government authorities like import and Export authorities etc.

III. **Cut – off Transactions:** The cut off transactions are checked in detail to ascertain whether (a) all goods dispatched have been billed and (b) bills are raised only against goods dispatched.

IV. **Transactions after balance Sheet date:** The transactions after the balance sheet date e.g. goods retuned etc. are checked to find out if they affect the sales account of the year under audit.

V. **Analytical Review:** The sales account should be analytically reviewed; if the products and prices are standard and constant during the year, sales should be equal to Quantity Sold x Standard Price.

a. Sales for the current year should be compared with the sales of the previous year. Any abnormal difference should be investigated.

b. Sales Quantity should be reconciled. Thus, Sales Quantity = Opening Stock + Production – Closing Stock.

c. Input – output ratio should be checked.

d. Various Turnover Ratios should be computed and compared Viz. (a) Sales to Net Capital employed. (d) Sales to Fixed Assets Employed. (c) Stock Turnover Ratio. (d) Debtors Turnover Ratio etc. Further, the profitability ratios viz. (a) Gross Profit to sales and (b) Net profits to sales should be computed and investigated.

VI. **Book Entries:** Auditor has to enquire (u/s 143) whether transactions of sales etc. are not mere book entries. Thus, if large sales are made to a concern towards the year end and these goods are returned immediately in the beginning of the next year, these may be fictitious sales to inflate profits.

VII. **Sales to Group Concerns:** Auditor has to ascertain whether total sales to a group concern during the year exceed Rs. 50,000. if so, he has to report whether the rates charged are reasonable compared to the market rates for similar items.

VIII. **Checking Trial Balance and Grouping:** Auditor should check the balance of Sales Account into the Trial Balance and the Grouping. He should see that –

a. No account in the nature of miscellaneous income e.g. Scrap sales is grouped under sales.

b. The debit balance in the Sales Return Account, if any, in the ledger is deducted form the gross sales amount.

IX. **Schedule III:** Auditor should see that the sales are classified as required by schedule III of the Companies Act. The value and quantities of major items are to be disclosed separately. Earnings in foreign currency from export of goods on F.O.B.

basis should also be disclosed by way of a note to the final accounts.

B. Other Income Account:

1. **Sample Checking:** Other Income accounts e.g. Scrap Sales, Rent Received, Dividends Received etc. being the incidental and not the main sources of income are scrutinized on sample basis.

2. **Cross – Checking:** Income amount is cross – checked with details available from other memorandum registers such as Scrap Sales Register, Property Register (for rent), Investment Register (for dividends, interest etc.) etc.

3. **Cut – Off transactions:** The Cut – off transactions are checked in detail to ascertain whether (a) income revised in advance and (b) income accrued are adjusted.

4. **Transaction after Balance Sheet Date:** The transactions after the balance sheet date e.g. sale of shares cum – dividend etc. are checked to find out if they affect the income account of the year under audit.

5. **Analytical Review:** The income account should be analytically reviewed i.e.

- If the items of scrap and prices are standard and constant during the year scrap sales should be equal to Quantity sold **X** standard price.
- Scrap Sales for the current year should be compared with the scrap sales of the previous year. Any abnormal difference should be investigated.
- Scrap Sales Quantity should be reconciled. Thus scrap sales quantity=Opening stock + Generation of Scrap – closing Stock.
- Input – Output ratio should be checked from the Production and cost records, to ascertain whether scrap generated is normal or not.

6. **Book Entries:** Auditor has to enquire (u/s 227 of the companies act) whether transactions are not mere book entries.

7. **Checking Trial Balance and Grouping:** Auditor should check the balance of the income account into the trial balance and the grouping. He should ensure that any major item in the nature of miscellaneous income is shown separately.

C. Income Accrued / Received in Advance:

1. Accrual Accounting: ‘Accrual” is the fundamental basis of accounting. A Limited Company must maintain its accounts on accrual basis. Under this basis, (a) income which has accrued is booked even if not actually received and (b) amount which is received in advance is not treated as income. This gives rise to (a) Income Accrued and (b) Income Received in Advance.

2. Accounting standard: Auditor should follow the guidelines contained in Accounting Standard 9 – Revenue Recognition – issued by the Institute of Chartered Accountants of India (ICAI) for this purpose.

3. Scrutiny of Income A/cs: Auditor should scrutinize all Income Account (especially accounts like Service Charges Recovered, Interest, Rent, Royalties and Dividends) to ascertain the amounts accrued or received in advance.

4. General Rule: As a general rule, income should be booked when it has accrued as per the terms of agreement between the parties.

5. Service Charges: Income from service charges accrues when the service is performed and complete. Thus income from job work (i.e. processing of material supplied by others) accrues when the job or processing is completed. If a job is complete at the year end, but not yet billed, auditor should ensure that the income from that job is shown as accrued and receivable in the books. On the other hand, if any amount is received but the job is not complete as at year end, it should be shown as income received in advance.

6. Interest Earned: Interest accrues on time basis at the rate agreed. Thus, if a loan agreement states that interest on a loan of Rs. 1,00,000 is payable @20% per year, interest for a year would be Rs. 20,000. If only Rs. 15,000 are received till the year end, interest of Rs. 5,000 has accrued and must be booked. On the other hand, if interest received is Rs. 25,000, Rs. 5,000 is received in advance and pertain to the next year. Auditor should scrutinize the interest account to ascertain the amount of interest accrued or Interest Received in Advance.

7. Rent: Rent also accrues on time basis at the rate agreed. Thus, if a rent agreement states that rent of Rs. 1,000 is payable per month, rent for a year would be Rs. 12,000. If only Rs. 10,000 is received till the year end, rent of Rs. 2,000 has accrued and must e booked. If on the other hand, Rs. 15,000 is received during the year, Rs. 3,000 should be shown as Rent Receivable in advance.

8. Royalty: Royalty means the charges for use of know – how, patents, trade marks and copyrights. Royalties accrue as per the terms of the concerned agreement.

9. Dividends: Dividends on share accrue when the dividend is declared by the shareholders. Auditor should enquire from the client whether any such dividend has been declared on the shares held as investment till the year end.

10. Prior Period Income: Prior Period Income means income credited to the current year's profit and loss account, though relating to earlier years, due to the omission to treat such income as income accrued during the concerned year. Such items should be disclosed separately in the profit and loss account.

D. Purchase Account:

1. **In – depth checking:** Purchase Account being the main item of expenditure is scrutinized in depth. The monthly summary is checked from the purchase Register and the debit / credit note register. Posting from cash/ bank/ journal are individual and not summary postings. These are checked on sample basis.

2. **Cross – Checking:** Total Purchase amount is cross – checked with figures of purchases in the sales tax returns, excise registers, returns with government authorities like import and export authorities etc.

3. **Cut – off transactions:** The cut – off transactions are checked in detail to ascertain whether (a) all goods received have been billed and (b) bills are booked only against gods received.

4. **Transactions after balance sheet date:** The transactions after the balance sheet date e.g. debit notes received, goods returned etc. are checked to find out if they affect the purchase account of the year under audit.

5. **Analytical Review:** The purchase account should be analytically reviewed i.e.

- If the raw material and prices are standard and constant during the year purchases should be equal to Quantity x rates.
- Purchases for the current year should be compared with the purchases of the previous year. Any abnormal difference should be investigated.
- Purchases Quantity should be reconciled. Thus, purchase quantity = Opening Stock + Consumption – closing stock.

- Input – output ratio should be checked, to ascertain whether purchases, consumption, production and stocks are consistent with each other.
- Purchase Ratios should be computed and compared viz. purchase to sales, purchases to Creditors etc.

6. **Book Entries:** Auditor has to enquire (u/s 227 of the companies act) whether transactions of purchases etc. are not mere book entries. Thus, if large purchases are made from a concern towards year end and these goods are returned immediately in the beginning of the next year, these may be fictitious purchases to suppress profits.

7. **Purchases from Group Concerns:** Auditor has to ascertain whether total purchases from a group concern during the year exceed Rs. 50,000. If so, he has to report whether the rates charged are reasonable compared to the market rates for similar items.

8. **Checking Trial Balance and Grouping:** Auditor should check the balance of the purchase account into the Trial Balance and the Grouping. He should see that –

a. No account in the nature of miscellaneous purchase e.g. gift articles purchased is grouped under purchases.

b. The Purchases Returns Account, if any, in the ledger is deducted from the gross purchases amount.

E. Other Expense Accounts

1. Sample Checking: Other Expenses account e.g. Manufacturing Expenses, Administrative and Office Expenses, Sales and Distribution Expenses etc. should be scrutinized on sample basis.

2. Cross Checking: Expenses accounts should be cross – checked with details available from other memorandum registers such as Excise Registers, Sales Tax Returns, Provident Fund Returns, Insurance Registers etc.

3. Cut – off Transactions: The cut off transactions are checked in detail to ascertain whether (a) all outstanding expenses and (b) all pre paid expense are adjusted.

4. Transactions after balance Sheet Date: Transaction after the balance sheet date e.g. payment of expenses etc. are checked to find out if they affect the expenses account of the year under audit.

5. Analytical Review: The expenses account should be analytically reviewed i.e.:

- If the items of stores and prices are standard and constant during the year stores expenses should be equal to Quantity X Rates.
- Major Expense for the current year should be compared with their corresponding figures of the previous year. Any abnormal difference should be investigated.
- Packing Material Quantity should be reconciled. Thus packing materials consumed = opening stock + purchases – closing stock.
- Major Expense Ratio should be computed e.g. (a) Manufacturing Expenses to Sales or (b) Selling andDistribution Expenses to sales. Any abnormalities should be investigated.

6. Book entries: Auditor has to enquire (u/s 143 of the Companies Act) whether transactions are not mere book entries.

7. Checking Trial balance and Grouping: Auditor should check the balance of the Expenses account into the trial balance and the grouping. He should see that any major item in the nature of miscellaneous expenses (i.e. exceeding 1% of the turnover) is shown separately.

F. Outstanding / Pre – paid expenses

1. Accrual Accounting: “Accrual” is the fundamental basis of accounting. A Limited Company must maintain its accounts on accrual basis. Under this basis,

a. Expenses which have accrued are booked, even if not actually paid, and

b. Amounts which are paid in advance are treated as per paid expenses. This gives rise to (a) Outstanding expenses and (b) Pre – paid expenses.

2. Scrutiny of Expenses A/c: Auditor should scrutinize all expense accounts (especially accounts like service charges paid, interest, rent, salaries, royalties etc.) to ascertain the amounts outstanding or prepaid.

3. General Rule: As a general rule, expenses should be booked when they have accrued as per the terms of agreement between the parties.

4. Service Charges: Services charges accrue when the service is performed and complete. Thus, charges for job work (i.e. processing by outsiders of materials supplied by the concern) accrue when the job or processing is complete. If a job is complete at the year end, but not yet billed, auditor should ensure that the service charges are shown as accrued and payable in the books. On the other hand, if any amount is paid but the job is not complete as at year end, it should be shown as pre paid expenses.

5. Interest Due: Interest accrues on time basis at the rate agreed. Thus, if a loan agreement states that interest on a loan of Rs. 1,00,000 is payable @ 20% per year, interest for an year would be Rs. 20,000. if only Rs. 15,000 are paid till the year end, interest of Rs. 5,000 has accrued and must be booked as outstanding expenses. On the other hand, if interest paid is Rs. 25,000. Rs. 5,000 are paid in advance and pertain to the next year. Auditor should scrutinize the interest account to ascertain the amount of Interest Outstanding or Interest Pre-paid.

6. Rent: Rent also accrues on time basis at the rate agreed. Thus, if a rent agreement states that rent of Rs. 1,000 is payable per month, rent for a year would be Rs. 12,000. If only Rs. 10,000 is paid till the year end, rent of Rs. 2,000 has accrued and must be booked as outstanding expenditure. If on the other hand, Rs. 15,000 is paid during the year, Rs. 3,000 should be shown as Pre – paid expenses.

7. Royalty: Royalty means the charges for use of know – how, patents, trade marks and copyrights. Royalties accrue as per the terms of the concerned agreement.

8. Salaries and Wages: Normally, salaries and wages of the last month of the accounting year would be outstanding at the year end. These amounts would be paid in the next month. While making the provision, provisions should be made for the gross salaries and wages i.e. including the employer's contribution to provident fund, ESIS etc.

9. Commission on Sales: Commission may be payable to sales staff, or outside agents. The amount of commission would depend upon the terms of agreement and the amount of sales. The auditors should verifies the computation of commission and ascertain the commission outstanding or pre – paid as on the year end. Auditor should verify that the appointment and terms of a sole selling agent are approved by the shareholders in a general meeting. Schedule III requires that commission to sole selling agents and must be disclosed separately.

10. Commission to Directors: Commission to directors must be in accordance with the provisions of the companies act.

11. Opening Balance: Auditor should check that the opening balance brought forward from the previous year in the outstanding expenses account is squared off during the current year. The difference between the provision for outstanding expenses brought forward and the actual payment in the next year must be properly adjusted.

12. Prior Period Income: Prior Period expenses are expenses debited to the current year's profit and loss account, though relating to earlier years, due to the omission to treat such expenses as outstanding expenses during the concerned year. Such items should be disclosed separately in the profit and loss account.

1.5 PRACTICAL ILLUSTRATIONS

Q.1 Why and how will you as an auditor, make a scrutiny of the following ledger account? What conclusions will you draw from such scrutiny?

Ajay's Ledger
Vineet's Account (LF No. 21)

Dr. **Cr.**

Date	Particulars		F.	Amount	Date	Particulars		F.	Amount
2001					2001				
					Apr.01	By balance b/d			400
2002					2002				
Mar.2	To Purchase Returns	A	1	1,000	Mar.1	By Purchases	A	1	5,000
Mar.7	To Payment	A	2	4,000	Mar.5	By Purchases	B	3	4,500
Mar.7	To Purchase Returns	B	3	900	Mar.26	By Purchases	C	6	9,000
Mar.9	To Payment	B	5	3,000	Mar.27	By Purchases	C	2	5,000
Mar.31	To bal. c/d			15,000					
				23,900					23,900

Solution:

1. **Name of the ledger :** Vineet's account in the books of Mr. Ajay.

2. **Nature of account :** Mr. Vineet is the supplier of Mr. Ajay and hence the nature is of personal account.

3. **Period of the ledger :** Mr. Vineet's account has covered one financial year from 2001-2002.

4. **Reason of scrutiny :** The reason of scrutiny of Mr. Vineet's account is that the auditor has to obtain audit evidence for the closing balance in the account is due and payable. He should also check the balance shown of Rs. 15,000 is correctly valued. The balance has been correctly valued in balance sheet.

5. **Check Casting :** The total of the both the sides of the account i.e. Rs. 23,900 is correct.

6. **Check opening balance :** the auditor can check opening balance of Rs. 400 from Creditors schedule from previous year.

7. **Check entries :** checking of the entries of an account shows :

1. **debit :** the debit side of the suppliers contains purchase returns and payment entries.

2. **Credit :** the credit side of the account contains the opening balance and purchase transactions.

8. **Carry forward :** the closing balance of creditor's account showing credit balance is normal. Debit balance in a creditors account means an advance payment. it should be carried forward in balance sheet.

9. **Transfer to balance sheet :** auditor should check if the balance in creditor's account has been correctly transferred to the balance sheet under appropriate heading and in schedule.

10. **Composition of closing balance :** The closing balance consists of Opening balance of 400 + purchases made on 26th and 27th March for Rs. 9,000 and Rs. 5,000 respectively + the difference between the purchase made on 5th March and goods returned and the payment made i.e. (4,500 – 900 – 3,000) = Rs. 15,000.

If the creditor's account has a closing balance, confirmation letter should be sent to the party. If the party does not confirm the balance, a certificate from the management has to be obtained for the balance payable. Auditor has to judge whether this amount is really payable. If the balance remains outstanding for an unreasonable duration, he shall make further inquiry.

Q.2 Why and how will you, as an auditor, make a scrutiny of the following ledger account? What conclusions will you draw from such scrutiny?

Lallan's Ledger
Mala's Account (LF No. 21)

Dr. **Cr.**

Date	Particulars		F.	Amount	Date	Particulars		F.	Amount
2002					2002				
Jan.1	To bal. b/d	A		10,000	Jan.1	By Purchase a/c	A	1	16,000
Jan.17	To purchase (CN for excess rate)	A	1	500	Mar.31	By bal. c/d	B		20,000
Jan.20	To bank	A	2	5,000					
	To discount	A	2	500					
Mar.25	To bank a/c	B	3	20,000					
				36,000					36,000

Solution :

1. **Name of the ledger :** Name of the ledger should be mentioned on top of every account.

2. **Nature of account :** Nature of account should be observed from the transactions. From the above ledger transactions we can observe Mala is a supplier / creditor of Lallan.

3. **Period of the ledger :** the period covered in above account is one quarter i.e. 01/01/2002 to 31/03/2002.

4. **Reason for scrutiny :** account should be scrutinized to obtain audit evidence that : a) closing balance shown is correct. b) the balance is properly valued. c) the balance is presented in appropriate heading in balance sheet and also in corresponding schedule.

5. **Check casting :** The totals of both sides (credit and debit) is should be same. In above case it is Rs. 36,000.

6. **Check opening balance :** opening balance of the creditor can be verified from the schedule of creditors as on the previous day of the opening balance i.e. as on 31st Dec, 2001 in above case.

7. **Check entries :** auditor should check the debit and credit side of the account.

1. **Debit :** Supplier's account has payments made, credit notes raised, discount entry and purchase return entries on the debit side.

2. **Credit :** Creditor's / Supplier's account will have credit opening balance. Auditor should inquire if supplier's account is showing debit balance.

All the purchase entries are on the credit side of the account.

8. Carry forward : The closing balance should be carried forward to respective schedule and under appropriate head in balance sheet.

9. Marking of payments : auditor should mark payment against corresponding invoice and credit / debit notes. This can be done as follows :

Against an invoice of Rs.16,000(A) advance payment of Rs.10,000(A) is made + a credit note is raised for Rs.500(A) + payment is made of Rs.5,000(A) and a discount of Rs.500(A) is availed. Balance is cleared against the bill.

10. Composition of Closing balance : Closing balance consist of an advance payment made on 25th March of Rs.20,000 (B).

1. If the advance payment made is returned in cash in the subsequent year, there is a possibility that it was a loan only disguised as advance against purchases.

2. If goods are supplied against advance payment, it means the payment made is genuine.

3. If advance payment is not cleared in subsequent year also, a letter of confirmation should be sent to the party. If the balance is not confirmed by the party then a certificate should be obtained from the management that such balance is recoverable.

11. Check the schedule : Auditor should check the debit balance in the nature of advance payment to creditor's is shown separately as advance on the asset side.

Q.3 Why and how will you, as an auditor, make a scrutiny of the following ledger account? What conclusions will you draw from such scrutiny?

Reema's Ledger
Madhumita's Account (LF No. 2)

Dr. **Cr.**

Date	Particulars		F.	Amount	Date	Particulars		F.	Amount
2001					2001				
Jan.1	To bal. b/d	A		6,000	Jan.1	By Bills Rec.	A	1	4,000
May25	To sales	B	1	5,000		By Returns	A	1	1,000
Sep.08	To bills rec.	C	3	2,500		By Bank	A	1	950
	To interest	C	3	500		By Discount	A	1	50
	To sales	C	3	7,000	Jan.5	By Bank	B	3	2,350
Dec.12	To bills rec.	D	6	8,000		By discount	B	3	150
	To interest	D	6	400		By Bills Rec.	B	3	2,500
Dec.15	To sales	E	7	5,000	Sep.8	By Cash	C	6	2,000
						By Bills Rec.	C	3	8,000
					Dec.14	By Cash	D	7	8,400
					Dec.31	By Bal. c/d	E		5,000
				34,400					34,400

Solution :

1. **Name of the ledger :** Above given is Madhumita's account in Reema's Ledger.

2. **Nature of account :** from the transactions it can be observed that the account that Madhumita is a debtor of Reema. The nature of the account is personal.

3. **Period of ledger :** The above ledger is for an entire calendar year i.e. from 01/01/2001 to 31/12/2001.

4. **Reason for scrutiny :** The scrutiny of the account is to be done to obtain audit evidence that :

a) Closing Balance shown is correct,
b) The balance is properly valued, i.e. the balance is Rs. 5,000 at the end of the year, no more, no less.
c) The balance is presented in appropriate heading in balance sheet and also in corresponding schedule.

5. **Check casting :** The total of both sides i.e. debit and credit should be same. In above case total of Rs. 34,400 is correct.

6. **Check opening balance :** The opening balance should be checked from the schedule of debtors of last year.

7. **Check entries :** Entries should be in chronological order.
a) debit side : The debit side of a debtors account contains opening balance, bills receivable honoured, interest received and Sales entries.
b) Credit Side : Credit side will have sales return entries, bills receivables and cash received entries.

8. **Carry forward :** Debtors account is a personal type of account and appears on the asset side of the balance sheet. It should be carried forward in appropriate schedule under balance sheet.

9. **Marking of Bills receivables against receipts :** in above case, the opening balance of Rs. 6,000(A) is settled by drawing a bill of Rs. 4,000(A) + sales return of Rs. 1,000(A) + Cash receipt of Rs. 950(A) and + a discount of 50(A).
All other transactions should be marked in a similar way for their respective bills.

10. **Closing Balance :** After marking of transactions, it can be observed that the balance at the yearend consists of sales made on 15th December.

The closing balance of the account is showing debit balance which is normally seen for debtors account.

The amount of Rs. 5,000 for sales made on 15th December, should be received in subsequent period. However, if the same is not received, the debtor shall make inquiry for the same. He shall also send a letter of confirmation to the party and get the balance confirmed at the year end. If, there is no confirmation received from the party, the auditor shall obtain a certificate from the management that such balance is receivable. From the frequency of the transactions, the auditor should judge if the balance is good or bad.

Q.4 Why and how will you, as an auditor, make a scrutiny of the following ledger account? What conclusions will you draw from such scrutiny?

Riya's Ledger
Bills Receivable Account (LF No. 28)

Dr. **Cr.**

Date	Particulars		F.	Amount	Date	Particulars		F.	Amount
2001					2001				
Jan.1	To balance b/d	A		10,000	Apr.30	By Bank	A	1	10,000
May1	To Ram	B		5,000	June2	By Bank	B	1	4,900
June6	To Balaram	C		10,000		By Discount	B	1	100
Aug.18	To Shyam	D		7,500	Aug.20	To Bank (Collection)	D	1	7,500
Sep.10	To Balaram	E		10,200	Sep.9	By Balaram	C	3	10,000
Dec.1	To Sitaram	F		5,000	Dec.1	By Atmaram	F	3	5,000
Dec.29	To Sangoram	G		7,000	Dec.31	By Balance c/d			17,200
				54,700					54,700

Solution :

1. **Name of the ledger :** The name of the account is bills receivable account in Riya's Ledger.

2. **Nature of the account :** Nature of bills receivable account is personal.

3. **Period of Ledger :** Period of ledger is for calendar year 01/01/2001 to 31/12/2001.

4. **Reason for scrutiny :** Auditor obtains audit evidence by doing scrutiny of the account. It provides evidence that the closing balance is correctly valued, opening balance is correctly carried forward from previous year and closing balance is shown in balance sheet under assets head.

5. **Check casting :** the total of debit and credit sides is same, Rs. 54,700.

6. **Check opening balance :** Auditor should check Opening balance of Rs. 10,000 is correctly carried forward from previous year's balance sheet.

7. **Check entries :**

a) **Debit :** The entries are in chronological order. The entries are of bills drawn of different debtors.

b) **Credit :** The entries on credit side represent Bills receivable honoured, and closing balance.

8. **Carry forward :** Bills receivable is a personal account and appears on the asset side of the balance sheet.

9. **Composition of closing balance :** Auditor should mark payment received against respective bills receivables drawn. In the above account closing balance consists of Bills drawn on Mr. Balram Rs.10,200 (E) and Mr. Sangoram Rs. 7000 (G).

Q.5 Why and how will you, as an auditor, make a scrutiny of the following ledger account? What conclusions will you draw from such scrutiny?

ABC Ltd.'s Ledger
Loan to Asha Ltd. Account (LF No. 2)

Dr. **Cr.**

Date	Particulars	F	Amount	Date	Particulars	F	Amount
2002				2002			
Jan.1	To Bank	2	60,000	June30	By Bank (1^{st} ½ yrly Installment)	10	15,000
				Dec.31	By Balance c/d		45,000
			60,000				60,000

Solution :

1. **Name of the account :** It is a loan account of Asha Ltd in the books of ABC

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2. **Nature of Ledger :** Nature of Loan to Asha Ltd account is personal.

3. **Period of Ledger :** The period covered is from 1^{st} Jan, 2002 to 31^{st} December, 2002.

4. **Reason of scrutiny :** Scrutiny of loan account shows that :
a) Repayments are correctly posted on the debit side (right side)
b) Entries are in chronological order.
c) Against each entry, reference of the folio of original book is mentioned.

5. **Check Casting :** The total of the account of Rs. 60,000 is correct.

6. **Check opening balance :** Opening balance can be verified from the balance sheet of previous year 2001.

7. **Check entries :**
a) **Debit Side :** Debit side of loan has loan given on 1^{st} January. Loan amount given should be in power of the lender. Loan has

been granted only after following proper procedures. Loan granted should be in accordance with respective sections of the Companies Act, 2013.

b) **Credit Side :** Loan repayments are on credit side of the account. The borrow should be competent to make loan repayments on time. The loan installment is paid only in June and it has not been paid. The borrower is a company the MOA should contain the power to borrow money.

8. **Composition of closing balance:** The closing balance of loan account has a debit balance which is normal for a borrowers account.

   The closing balance consists of pending loan after payment of first installment.

   Auditor should check if the same is paid in next year, if the loan is good or doubtful. He should also check if the interest payments with respect to loan instalments are received on time.

Q.6 Why and how will you, as an auditor, make a scrutiny of the following ledger account? What conclusions will you draw from such scrutiny?

Surya Ltd.'s Ledger
Donation & Charity Account (LF No. 77)

Dr. **Cr.**

Date	Particulars	F	Amount	Date	Particulars	F	Amount
2003				2003			
Jan.1	To SARS Relief Fund	BF6	60,000	Mar.31	By P&L A/c (transfer)	JB8	1,50,000
Mar.10	To BJP Fund	BF9	50,000				
Mar.20	To National Defense Fund	BF9	40,000				
			1,50,000				1,50,000

Solution :

1. **Name of the ledger :** The account is a donation account.

2. **Nature of the account :** Donation / charity account is a nominal account.

3. **Period of the ledger :** it has covered period from January 2003 to March 2003.

4. **Reason for Scrutiny :** The reason for scrutiny is to obtain evidence that the amount treated as expense is correct and is correctly disclosed in Profit & Loss Account.

5. **Check casting :** The total of both sides, Rs. 1,50,000, is correct.

6. **Check opening balance :** Nominal accounts do not have opening or closing balance.

7. **Check entries :** Auditor should check contributions made are on debit side of the account and are not directly related to business of the company or welfare of employees. He should check donations are within the limit of section 181 of Companies Act 2013. If the donations exceed the prescribed limit of donation, he should qualify the report.

   Donations made to political party are governed by section 182 of the Companies Act 2013. Donations exceeding prescribed limit amount to qualifying the report.

   Donations of National defence fund is governed by section 183 of the Companies Act, 2013. The section empowers the Board of Director to make such contributions.

8. **Transfer to P&L A/c :** The balance of nominal account is to be transferred to Profit and loss account at the yearend.

9. **Closing Balance :** Nominal account do not have any closing balance. The entire amount is to be transferred to P&L Account and are separately disclosed.

Q.7 Why and how will you, as an auditor, make a scrutiny of the following ledger account? What conclusions will you draw from such scrutiny?

Sadhabahar Ltd.'s Ledger
Provision for Tax Account (LF No. 30)

Dr. **Cr.**

Date	Particulars	F	Amount	Date	Particulars	F	Amount
2002				2002			
June1	To Advance Tax A/c (A) [2001-02]	JF8	1,40,000	Apr.1	By Balance b/d (A) [2001-02]		1,20,000
June1	To Liabilities for Tax A/c (A)	JF8	12,000	June1	By P & L A/c (A)	JF8	32,000
2003				2003			
Mar.31	To Balance c/d [B]		1,60,000	Mar.31	By P & L A/c (B)	JF9	1,60,000
			3,12,000				3,12,000

Solution :

1. **Name of account :** The name of the account is Provision for tax

2. **Nature of account :** The nature of provision for tax is a provision account created through an Adjustment entry passed at the yearend.

3. **Period of the ledger :** The period of the ledger is FY 2002-03.

4. **Reason for scrutiny :** The reason for scrutiny is to obtain audit evidence for the balance of amount is really payable. The balance is properly valued and is properly valued.

5. **Check casting :** The total of both sides Rs. 3,12,000 is correct,

6. **Check opening balance :** the opening balance is Rs.1,20,000 is for previous year. The assessment order for this year passed by income tax department is received during the year in June 2002. Hence, the advance tax paid for that year 1,40,000 is transferred from the Advance Paid account. The debit of 32,000 in the P&L A/c shows the amount of shortfall in the provision. It means the tax due as per the assessment order is 1,52,000. And the advance tax paid of 1,40,000 is credited to the liability for tax account.

   Auditor should check the assessment order for this year. He shall report the same in his CARO Report.

   The provision for current year is made for Rs. 1,60,000. He shall check the computation of the tax.

7. **Composition of closing balance :** the closing balance of 1,60,000 is made up of provision for tax payable on income for current year. It is on the credit side of account which is normal.

8. **Transfer of the balance :** The final balance of provision account should be presented in the schedule of Provisions.

1.6 AUDIT OF MAIN JOURNAL

The main journal contains :
(i) Adjusting entries.
(ii) Closing entries.
(iii) Rectification entries.
(iv) Entries which cannot be accommodated in any other subsidiary book or journal (e.g., credit sale of fixed asset, credit purchase of fixed asset, share allotment, share capital, creation of capital redemption reserves, and initial recognition of finance lease)

Points to be kept in mind while auditing the main journal:

(1) Opening entries- Verify opening entries with the audited balance sheet of the previous year.

(2) Rectification entries - Refer to the original vouchers in respect of which error was committed to ensure that rectification entries are genuine and rectification entries have been correctly passed.

The auditor should not assume that every rectification journal entry is a genuine rectification of an actual error. He should exercise enough professional skepticism in this matter.

For Example : Cheque received from Mr. Shah is credited to Mr. Saha's account. Then after 10 days, the "mistake" is discovered. It is "rectified" by debiting A. Saha and crediting A. Shah. Only thing is that the data entry man had a "setting" with A. Shah who told him that he won't be able to send his cheque within the time allowed for availing cash discount and further, if somehow he is allowed the cash discount, he would "share" it with him. Accordingly the above 'mistake' was committed to give A. Saha the discount which he was not entitled to.

(3) Supporting Documents - Examine the supporting documents such as correspondence, contracts, minutes etc.

(4) Adjusting entries - Adjusting entries are passed for—

(a) expenses accrued till the balance sheet date but not paid e.g., rent, electricity, etc.

(b) income accrued but not received e.g., interest accrued but not matured for receipt.

By the time of audit, some of the liabilities provided for may have already been paid off. The payments may be more than the provision. But as long as these were estimated on a reasonable basis, the auditor need not insist on adjusting the difference between the provision and the payments.

Since adjustment entries are supported by internally prepared statements, the auditor should obtain independent evidence for corroborating them.

If the difference between amount provided for and amount settled is material, the auditor should insist on management increasing the provision amount.

5) Journal entries not supported by any vouchers like bills, contracts, etc. - If any journal entries are not supported by vouchers (except opening entries rectification entries, adjusting entries and closing entries) the auditor should see whether these are transactions represented merely by book entries prejudicial to the interest of the company [section 143 of the Companies Act, 2013].

6) Proper authorization -The auditor should ensure that journal entries are passed with proper authorization.

7) Non-standard journal entries - Perform tests of non-standard journal entries to confirm that they are adequately supported and reflect underlying events and transactions. This may help in identifying fictitious entries or aggressive recognition practices. Non-standard journal entries are generally the financial statement changes or entries made in the books and records (including computer records) of the entries that are :

- ♦ Usually initiated by management level personnel; and
- ♦ Not routine or associated with normal processing of transactions.

1.7 BALANCE SHEET AUDIT

MEANING OF BALANCE SHEET AUDIT

Until recently, test checking was confined to confirming balances in a few nominal account such as stocks and stores, amount of sales and other similar records relevant to trading transaction, which were voluminous but of similar nature. Now-a-days test checks are being applied widely for verification of income and expense accounts and assets and liabilities as well. This is due to two reasons:
(i) Increase in the size of business units, and
(it) Computerization of accounting.

DEFINITION –

A balance sheet audit consists of the verification of all the balance sheet items along with the examination of expense and income accounts which are so closely related to those items that it cannot be properly verified without such analysis and test.

Balance sheet audit will include

(i) Examination of partnership deed, the memorandum and articles of association, minute books and the system of accounting in force.

(ii) Verification of ownership or enterprise's control over assets shown in the balance sheet.

(iii) Proof that all assets owned or controlled by the enterprise are included.

(iv) Inclusion of assets in the balance sheet is in accordance with the generally accepted principles of accounting (valuation of assets).

(v) Proof that all liabilities are included and at actual amounts.

(vi) Examination of closing and adjusting entries and any other entries relevant to the preparation of balance sheet.

(vii) Distinction between capital expenditure and revenue expenditure on the basis of accepted accounting principles.

(viii) Proof that share capital issues have been made in compliance with requirements of law and they are correctly recorded in the financial books.

(ix) An analysis of the charges and credits to the profit and loss accounts and the inclusion of the resultant balance in the balance sheet.

1.8 SUMMING UP

The ledger is a permanent book of record which contains a number of accounts of different subjects. Its purpose is, therefore to provide classified financial information about the subjects such as a person, asset and an expense or income. The fundamental double-entry principle provides that debit is always equal to credit or vice versa. Since the ledger account is prepared under the double-entry system, it helps to prepare a Trial balance that provides a check on the arithmetical accuracy for recording transactions in the books of accounts. The ledger is a book of accounts relating to all the financial transaction of the business. It contains the accounts of all expenses, losses, incomes and gains. Therefore, it helps to prepare the profit and loss account of the business so as to ascertain the profit earned or loss suffered during a specified period. The ledger also contains the accounts of the financial transactions relating to capital, all liabilities and assets of the business. With the help of the balances of these accounts and profit and loss of the business, a balance sheet may be prepared to show its financial position at a certain point in time.

1.9 QUESTIONS FOR EXERCISE

1. Discuss Importance and objective of Audit of ledger.
2. How as an auditor scrutiny of bought ledger is done.
3. How as an auditor scrutiny of Sales ledger is done.

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2

THE COMPANY AUDIT I

Unit structure

2.1 INTRODUCTION

The provisions related to the Audit of a company must be studied to understand the procedure to be followed by the company auditors. However, for better understanding of the Audit procedure it is essential to study provisions relating to the accounts of the company contained from Section 128 to section 138. Provisions relating to the accounts of the company are summarized as below

Maintenance of Books of Accounts

Section 128 of the Companies Act, 2013 - every company shall keep at its registered office or any other place in India after complying with relevant prescribed procedures proper books of account to record- (i) all sums of money received and spent & related matters. (ii) all sales and purchases (iii) all assets and liabilities (iv) such cost records prescribed by Central Government (CG) in case of Companies engaged in production, processing, manufacturing or mining activities.

Section 128 has laid two conditions for proper books of account viz. (i) True and fair view of the company performance & consequent state of affairs explaining its transactions & (ii) Double Entry and Accrual basis of accounting.

Branch Returns

In case of any branches, it shall be ensured that proper summarized quarterly returns of transactions occurred are to be sent to registered office.

Preparation & Presentation of the Final Accounts

Section 129 of the Companies Act, 2013 deals with the preparation & presentation of the final accounts of companies.

Preservation of Books of Accounts

The books of accounts (with vouchers) for **proceeding eight years** should be preserved.

Financial Statement for relevant Financial Year

The Annual Accounts of profits & loss (or Income & Expenditure as case may be) and Balance Sheet together with Directors' Report must be laid by the Board of Directors (BOD) before every Annual General Meeting (AGM) relating to period called "Financial Year".

The Financial Year in such case may be less, equal or more than a calendar year with maximum 18 months and the ending date of the financial statements of final accounts shall generally not proceed the date of the AGM by more than 6 months unless permitted by the Registrar of Companies (ROC).

Responsibility of Directors

The responsibility for complying with the provisions of the Companies Act is that of the Directors or competent reliable duly authorized persons.

Maintaining Statutory Books

In addition to the books of account, a company has to maintain certain relevant statutory books as follows-

(i) Register of Members (ii) Index of Members (iii) Register & Index of Debenture holders (iv) Register of Charges (v) Minute Books (vi) Register of Directors (vii) Register of Investment made in shares, (viii) Register of Investments (ix) Register of Loans under different sections/provisions applicable.

2.2 PREPARATION, PRESENTATION OF ACCOUNTS AND AUDIT THEREOF

2.2.1 PREPARATION OF FINAL ACCOUNTS

(i) The Balance Sheet and the Profit & Loss Account (B/S & P/L) shall be presented compulsorily in vertical format with main items therein & detailed items in supporting schedules thereto and must comply with the requirement of Part I and Part II of schedule III and relevant accounting standards (AS) respectively disclosing the prescribed assets & liabilities and revenues as well as expenses respectively.

(ii) Disclosure of the following aspects pertaining to non-compliance of AS by ICAI or National Advisory Committee thereon in its final accounts viz. B/S & P/L viz. (a) Deviations (b) Reasons (c) Effects.

(iii) Exceptions to the above applicable provisions to be complied by companies-

(a) Special/Class of Companies like Banking, Insurance, Electricity governed by separate Laws/Acts appropriate to them.

(b) Where and when Central Government (CG) exempts any companies or modifies the requirement/disclosures.

(iv) Abridged Accounts- Form & Contents of B/S & P/L and Reports of Auditors & Directors.

2.2.2 GENERAL CONSIDERATION IN A COMPANY AUDIT

The statement of Auditing practices issued by the ICAI lays down the following general considerations in a company Audit.

1) **True and Fair**

The Audited Financial Statements must clearly show the results of the working of the company for the year and it should be in accordance with the provisions of schedule III of the Companies Act, 2013. The profit or loss for the year must disclose True & Fair view.

2) Materiality

Every material fact must be properly disclosed for e.g. prior period adjustments non-recurring or unusual items of income/losses. The concept of materiality is a subjective concept. The judgment of materiality needs auditor’s professional experience.

3) Analytical Study

While giving previous year figures a proper scrutiny should be made. Scrutiny can be made with the help of various ratios and proper explanations must be sought from the client if there is any significant variation. Auditors should also examine corroborative evidences to verify consistency of explanations given by the management.

4) Accounting Policies

The accounting policies followed by the client must be in conformation with the Accounting Standards and recommendations of the ICAI. The policies must be in consistency with the basic accounting principles.

5) Internal Control

The auditor should carefully examine the existing internal control before preparing Audit programme. He may use Flow Charts and Internal Control Questionnaire. The analysis of internal control will help to plan extent of audit procedure to be used by the auditor. In the areas of weaker internal control, auditor must apply more rigorous procedures. Any recommendations to improve the internal control should also be mentioned in the audit report.

6) Auditor's Approach

The auditor's approach should be professional, independent as well as without prejudice to his statutory duties. He must follow professional ethics in discharge of his duties.

7) Disclosure

The Auditors should ensure that there is proper disclosure of all relevant facts and information, matters required by Company Law and Accounting Standards. Contingent Liabilities must be properly disclosed.

8) Proper Books of Accounts

Section 209 and Section 541 of the Companies Act, 2013 requires the Auditor to report whether proper books of Accounts have been kept by the company or not.

9) Objectives

a. Assets - The Auditor's objective in regards to assets generally is to satisfy that the assets are existing, and they belong to the client. They are in possession of the client and they are not subject to any charge and they are properly valued.

b. Liabilities – Auditor should satisfy himself that all the liabilities are properly recorded classified and disclosed. He should also satisfy himself that the liabilities are actual liabilities and are not mere book entries.

10) Working Papers

Auditor must maintain proper and adequate working papers showing clearly work done by him/his assistants. Explanations and information given by the client and whether he satisfied with such information.

11) Computerized Accounts

If the accounts are computerized then he should modify the Audit programme and Audit work accordingly.

12) Reporting

This is the final and most important stage of Auditing. He should take great care in drafting the report. If he feels necessary to qualify his reports then he must qualify the same without any hesitation but with utmost care. The form of Audit Report is prescribed by the statute.

2.2.3 PRE-COMMENCEMENT CONSIDERATIONS

According to the 'Guide to Company Audit' issued by the ICAI before commencing the Audit the auditor should make him familiar with

a) Accounting year

b) Nature of company's business (examine the incidence of any other statue, of the company e.g. The Banking Regulations Act, 1949. The Insurance Act, 1938)

c) Status of the company with reference to sections Section 2(20), 2(46), Section 8 (except sub-section (9), Section 14 and Section 2(45)

d) Constitution and Composition of the Board of Directors

e) Important provisions of Memorandum and Articles

g) List of books of Accounts

h) Compliance to section 139, 140, and 141 of Companies Act, 2013 regarding to appointment of auditors.

i) Communication with previous Auditor, if the appointment is in replacement of existing auditor

j) Review of previous Audit notes and Audit Report

k) Any points arising from previous year's audit report/work.

l) System in place regarding internal control and internal check with reference to their effectiveness.

m) Whether the statement issued by the Institute or Accounting Standards have been considered.

n) Whether his independence can any way be affected in his duties.

2.2.4 VERIFICATION OF THE CONSTITUTION AND POWERS

A) Registration Documents

The registration documents are important documents for functioning of the company. The company shall carry its functions within the limits prescribed by them. It is important that the auditor should examine the **Memorandum of Association and the Articles of Association.**

B) Decision only in Board Meetings

As per section 179 following decisions must be taken in the Board Meetings and supported by proper Board Resolutions.

(*a*) to make calls on shareholders in respect of money unpaid on their shares;

(*b*) toauthorise buy-back of securities under section 68;

(*c*) to issue securities, including debentures, whether in or outside India;

(*d*) to borrow monies;

(*e*) to invest the funds of the company;

(*f*) to grant loans or give guarantee or provide security in respect of loans;

(*g*) to approve financial statement and the Board's report;

(*h*) to diversify the business of the company;

(*i*) to approve amalgamation, merger or reconstruction;

(*j*) to take over a company or acquire a controlling or substantial stake in another company;

(*k*) any other matter which may be prescribed

C) Decision only in General Meetings

i) Appointment & fixation of remuneration of Auditors

ii) Declaration of dividends

iii) Appointment of relatives of Directors to place of profit (section 188)

iv) Sell, lease or otherwise dispose off the whole or substantially the whole undertaking of the company

D) Minute Books

The Auditor must verify the Minute Books regarding

i) Loans to Director properly sanctioned by the Central Government (Section 185)

ii) Appointment of Directors

iii) Disqualifications of Directors

iv) General Powers of the Board (Section 179)

v) Donation to political parities , if any (section 182)

vi) Participating in voting by interested Director (section 300 of Companies Act 2013)

vii) Disclosure of interest by Directors (section 184)

viii) Register of Contract, Firms or companies in which Directors are interested (section 189)

ix) Remuneration of Directors (section 197)

x) Restrictions on Directors holding place of profit (section 188)

xi) Restriction on compensation for loss of office to a Director (section 202 and 191)

xii) Restriction on loans to company under samemanagement (section 67)

xiii) Inter-corporate loans & investments

2.3 AUDIT OF CERTAIN PAYMENTS

According to the guidance note on Audit of payments issued by the ICAI, the auditor should carry out appropriate Audit procedure in respect of following items as per the provisions of Companies Act, 2013.

A) Managerial Remuneration

i) Articles of Association or Resolution

The Auditor should see that the remuneration paid/payable to the managing director, whole time director is determined by the Articles of Associations of the company or by Resolution passed in General Meetings of the company.

ii) Company's Act

The auditor must verify that the provisions of Companies Act, 2013 are not violated while paying managerial remuneration. Section 197 of the Companies Act, 2013 mentions the maximum limit for payment of managerial remuneration by a public company to its managing director, whole-time director and manager which shall not exceed 11% of the net profit of the company in that financial year computed in accordance with section 198.

iii) Payment for Professional Services

The payments made towards the managerial remuneration should not include any payment made towards services rendered of a professional nature

iv) Mode of Payment

A director or manager may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by the other.

v) Calculation of Net Profit

The net profits for the purposes of this section shall be computed in the manner referred to in section 198.

vi) Sitting Fees

A director may receive remuneration by way of fee for attending meetings of theBoard or Committee or for any other purpose as may be decided by theBoard. However, the amount of such fees shall not exceed the amount as may be prescribed.

vii) Penalty for contravention

If any person contravenes the provisions of this section, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

B) Charity, Donations & Similar Contributions

i) Companies Act, 2013-

If the donations/contributions are made by the company to charitable or other funds not directly related to the business of the company or for welfare of the company then

a) It should be according to section 181 i.e. it should be passed in General Meeting & should not exceed 5% of average Net Profit of the company made during immediately preceding three financial years.

b) The auditors shall check the provisions of the Articles of Association regarding the powers of the directors to make such contributions.

c) The auditor should ask for a statement containing total contributions made during the year.

C) Prohibitions and restrictions regarding political contributions - Section 182

Companies allowed to make contributions

A company, other than a Government company and a company which has been in existence forat least three financial years, may contribute any amount directly or indirectly to any political party

Limit of Contribution

The aggregate of the amount which may be so contributed by the company in any financial year shall not exceed 7.5 per cent of its average net profits during the three immediate preceding financial years.

Resolution of the Board of Directors

No contribution shall be made by a company unless a resolution authorising of such contribution is passed at a meeting of the Board of Directors.

Contribution to any activity to support political party

A donation or subscription given by a company on its behalf or on its account to a person who is carrying on any activity which may be regarded as likely to affect public support for a political party shall also be deemed to be contribution of the amount of such donation, subscription for a political purpose.

Political souvenir

The amount of expenditure incurred by a company on an advertisement in any souvenir, brochure, tract, pamphlet etc issued by or on behalf of a political party, will be a contribution to such political party.

Disclosure in P & L A/c

Every company shall disclose in its profit and loss account any amount or amounts contributed by it to any political party during the financial year to which that account relates, giving particulars of the total amount contributed and the name of the party to which such amount has been contributed.

Contravention of Provisions

If a company makes any contribution in contravention of the provisions of this section, the company shall be punishable with fine which may extend to five times the amount so contributed and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months and with fine which may extend to five times the amount so contributed.

Vouching for Political Contribution

i) The auditor should check the provisions of Companies Act, 2013 regarding "prohibitions and restrictions regarding political contributions i.e. Section 182.

ii) If the Auditor is not satisfied he should qualify his report accordingly

iii) He should obtain a certificate from Board of Directors stating that such contributions are as per section 182 and are included in the books of accounts.

iv) Relevant proofs such as receipts must be checked.

D) Contributions to Defense Funds

i) Any contribution to National Defense Fund or any other fund approved by Central Government must be as per provision of section 183.

ii) Such donations need not be empowered by the memorandum of Association of the company.

ii) The total amount of such contribution must be properly disclosed in the profit & loss statement.

E) Director's Remuneration

Following points must be remembered while vouching director's remuneration

i) Conditions of Appointment

Appointment related terms as per the resolution of General Meetings or Board Meeting for appointment & his remuneration.

ii) Mode of Payment

Examine the Articles of Association & General Meeting Resolution and verify the mode of payment i.e. monthly, quarterly, yearly, etc.

iii) The terms of agreements

Check the terms of agreements with the Director

iv) Attendance

Verify the director's attendance in the Board Meetings

v) Verify Compliance

Check compliance with sections 197,198, schedule II and Schedule XIII.

vi) Disclosure

As per revised schedule III there is no disclosure requirement for Director Remuneration

vii) Receipts issued

Verify the receipts issued by the Director

F) Directors' Commission

i) Articles of Association must be checked regarding rules for payment of commission to Directors

ii) Check the agreement with the Director to verify the rate of commission

iii) Check the compliance with section sections 197,198, schedule II and Schedule XIII of Companies Act, 2013

iv) Check the calculation of the commission paid

v) Verify the receipts issued by the Director

G) Director's Sitting Fees

i) The payment of Directors Fees should be as per Articles of Association of the company

ii) Also verify the Board Resolution fixing the amounts of fees per meetings

iii) Check the minute book, Directors attendance register, Dates of the meetings.

iv) Check the calculation & verify the signatures of the Director

H) Expenditure on Corporate Social Responsibility

i) CSR Committee

Every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a Corporate Social Responsibility Committee.

ii) Constitution of the Committee

Corporate Social Responsibility Committee shall consist of three or more directors, out of which at least one director shall be an independent director.

iii) Board's report

The Board's report under section 134 shall disclose the composition of the Corporate Social Responsibility Committee.

iv) Duties of CSR Committee

(*a*) formulate and recommend, Corporate Social Responsibility Policy relating to the activities to be undertaken by the company;

(*b*) recommend the amount of expenditure to be incurred on the CSR activities; and

(*c*) monitor the Corporate Social Responsibility Policy of the company from time to time.

v) Limit of Expenditure

The company shall spend, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy.

For the purposes of section 135 "average net profit" shall be calculated in accordance with the provisions of section 198.

I) Payment of Dividend (profit made by a company is distributed to shareholders by way of dividend)

a) Verification of procedures

1) Examination of compliance with laws, regulations, and other relevant information

2) Examination of records

II) Examination of Compliance with provisions of compliance with Companies Act, 2013.

A) Section 123 –Declaration of Dividend

Dividend can be paid out of followings mentioned below:

i. Profit of the current year after providing the depreciation; or

ii. Profit of the previous financial year or years after providing for depreciation for previous years; or

iii. Out of the money provided by Central or State Government for payment of dividend in pursuance of guarantee given by that, if any.

B) Charging Depreciation

In terms of the provisions of section 123 of the Act, no company can pay dividend in any year without charging depreciation in the profit and loss account for the current year and that there is no balance of un provided depreciation of any earlier year or years.

Depreciation shall be provided in accordance with the provisions of Schedule II to the Companies Act, 2013.

C) Transfer portion of profit in reserve

Before declaration of dividend, a company may transfer a portion from the profit to the reserves of the company. The company is free to decide the percentage for such transfer to the reserve.

It's not mandatory to transfer the amount. Earlier in Companies Act, 1956 it was Compulsory to transfer the amount in reserve while declaration of dividend. But the same is on the discretion of the Company in Companies Act, 2013.

D) Process for declaration of Dividend

i. Company in Board Meeting may decide the amount of dividend which they want to recommend in General Meeting.

ii. Company will mention the resolution for Dividend in the Notice of General Meeting.

iii. Company will hold the General Meeting

a. Declaration of Dividend is Ordinary Business.

b. Ordinary Resolution for declaration of dividend will be passed in the General Meeting.

iv. Once dividend is declared, it must be paid within 30 days.

Note

i. Dividend declared in General Meeting cannot exceed the dividend recommended by the Board.

ii. Dividend declared in General Meeting by member can be less than the dividend recommended by the Board.

iii. Dividend paid in General Meeting is Final Dividend.

E) Interim Dividend

Interim dividend is the dividend which is declared between two Annual General Meetings of a company. Interim dividend is declared when the company makes good profit in the first half of the financial year. I.e. declared before the end of the financial year.

i. Interim dividend can only be declared by Board of Directors.

ii. Generally paid in the middle of the year, if Board of directors find that profitability of the Company.

iii. Board of Directors can declare dividend out of surplus in profit and loss account at the beginning of the year or profit during the year.

F) In case of Company incurred losses in current financial year

If the company has incurred loss during the current financial year upto the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends by the company during the immediatepreceding three financial years.

Note

i. Interim dividend is declared to keep the shareholders happy and keeping good image of company in the stock markets.

ii. All legal provisions applicable on final dividend equally apply on interim dividend.

G) Condition common for both Final Dividend and Interim Dividend

i. Deposit of Amount of declared dividend in separate Bank Account.

ii. Payment of dividend within 30 days of declaration.
iii. Transfer of unpaid dividend in special account.
iv. Interest for late payment
v. Transfer of Investor protection Fund after Seven year.
vi. Penalty for nonpayment etc.

H) Mode of Payment of Dividend

There are following Modes of Payment of Dividend [Section-123(5)]

a. Cash
b. Cheque
c. Dividend Warrant
d. In any electronic Manner.

I) Prohibition on Dividend

A company which has default under Section 73 and 74 related to deposit and repayment of deposit or interest thereon may not declare dividend.

J) Free Reserve

No dividend shall be paid from its reserves other than free reserves.

K) Punishment for Failure to Distribute Dividends

Dividend declared BUT has not been paid or dividend warrant has not been posted within 30 days from the date of declaration

Every director of the company, if knowing a party to the default PUNISHABLE WITH Imprisonment – which may extend to 2 years; and **Fine** – At least Rs. 1,000 for every day during which such default continues; AND Company shall be liable to pay simple interest at the rate of 18% p.a. during the period for which such default continues.

L) No Punishment for Failure to Distribute Dividends under Specified Cases

(i) Dividend could not be paid due to operation of any law

(ii) Dividend could not be paid due to any default which was not on the part of the company

(iii) Exception to punishment for failure to distribute dividends

(iv) Dividend has been duly adjusted against any dues from shareholders

(v) Any dispute regarding right to receive the dividend

(vi) Direction of shareholder to pay dividend can not be compiled with & same has been communicated to him.

N) Some Important Points to be kept in mind

i. Declaration of dividend and amount to be transferred to reserve is responsibility of the Board.

ii. Bona fide decision of Board in respect of dividend cannot be challenged.

iii. The dividend should be declared unconditional and must be paid within 30 days.

iv. Dividend on equity shares can be distributed only after dividend on preference shares is declared.

v. The amount of the dividend, including interim dividend, shall be deposited in a schedule bank in separate account within 5 days from the date of declaration of such dividend.

O) Unpaid Dividend

The amount of dividend which remains unpaid or unclaimed after 30 days from the date of declaration should be transferred to a special dividend account of the company.

- Account shall be called 'Unpaid Dividend Account' opened by the company in any scheduled bank.
- Amount of unpaid dividend shall be transferred to 'Unpaid Dividend Account' within seven days from the date of expiry of the 30 days period provided for payment of dividend.
- The company shall prepare a statement related to persons to whom unpaid dividend are to be paid and such statement shall place on the website of the company or any other website as approved by the Central Government.
- Such statement shall contain following information
  - ✓ Names of such persons to whom unpaid dividend are to be paid; and
  - ✓ Their last known address; and
  - ✓ Amount of unpaid dividend.
- After transferring the unpaid dividend to 'Unpaid Dividend Account', any person (who is entailed to claim such money) may apply to the company for payment of money so claimed.
- Any amount in the Unpaid Dividend Account of the company which remains unclaimed and unpaid for a period of seven years from the date of transfer of such amount to the Unpaid

Dividend Account should be transferred to the Investor Education and Protection Fund.

- Any interest earned on the Unpaid Dividend Account should be transferred to the Investors Education and Protection Fund.
- The company shall send a statement containing details of such transfer to the authority which administers the Fund and such authority shall issue a receipt to the company as evidence.

III. Vouching Payment of Dividend

a) FEMA

The Auditor must verify compliance with provisions of Foreign Exchange Management Act, 1999, in case if the shares are issued to non-residents or issue of ADR/GDR

b) Listing Agreement

The Auditor must verify that prior intimation regarding Board Meeting for declaring the dividend was given to the stock exchange.

c) Interim Dividend-

The Auditor must verify

- It is approved in the General Meeting of the members
- It is as per the Articles of Association/byelaws.
- The financial statements have been prepared and presented before the board
- The depreciation for the full year has been provided
- Transfer to reserve has been complied
- Dividend payable to preference share holders is paid/provided

d) Audit Procedure for Dividend

The Auditor should examine

- Minute Book or Board and General Meeting to check the rate of dividend
- Legal provisions relating to dividend have been fully complied with
- Pass books / bank Statement for the amount paid as dividend
- Amount transferred to special bank account for unpaid/unclaimed dividend
- Reconciliation of Balances and special bank A/C's with the unclaimed dividend account shown under the heading other liabilities in the Balance Sheet
- Relevant journal entries and its posting penalty for failure to distribute dividend. (Sec.127)

e) Dividend out of Capital Profits

If capital profits are distributed as dividend, the Auditor should also verify that

- The Article of the byelaws or other laws & regulations applicable to the entity, permit such distribution.
- It has been realized in cash
- The board or similar authority as satisfied that net aggregate value of the assets remaining after distribution of that profit will not be less than book values so that share capital & reserves remaining after the distribution will be fully represented by remaining assets
- Capital surplus arising on the revaluation of fixed assets is not directly or indirectly available for distribution as dividend.
- Any reserve in the nature of capital reserve arising on acquisition of a business as a going concern or on amalgamation in the nature of purchase & securities premium collected on the issue of securities cannot be utilized for declaration of dividend.

2.4 DISCLOSURE OF ACCOUNTING POLICIES

2.4.1 Accounting Standard 1

Accounting Policies are specific accounting principles and methods of applying those principles adopted by the company in the preparation & presentation of final statements.

Following are the areas in which different accounting policies are adopted by the different companies.

- Methods of depreciation/amortization.
- Valuation of fixed assets
- Valuation of investments.
- Valuation & treatment goodwill.
- Valuation of inventory
- Treatment of retirement benefits.
- Conversion of foreign currency items.
- Revenue recognition in case of long term contacts.
- Treatment of expenditure doing construction.
- Treatment of contingent liabilities.

2.4.2 Manner of Disclosure

- Should form part of financial statements.
- Should be disclosed at one place.
- If any change which materially affects current or future period should be disclosed

- if the affected amount is ascertainable the disclosure to that extent is required.
- If it is not ascertainable than it should be indicating.

2.4.3 Disclosure not required

If fundamental accounting assumptions are followed i.e. going concern, consistency and accrual are followed than no separate disclosure is required.

2.4.4 Major considerations in application of accounting policies

i) Prudence – Due to existence of future uncertainties of events profits are not anticipated but are recognized only when realized. All known losses and liabilities are provided even through the amount cannot be determined with certainty.

ii) Substance over form – The accounting treatment and presentation in financial statement of transactions and events should be governed by their substance and not merely by the legal form.

iii) Materiality – All material items should be disclosed in the financial statements i.e. items the knowledge of which might influence the decisions of the users of the financial statements.

2.5 AUDIT OF LIABILITIES

In addition to routine procedures following procedures should be adopted by the auditor.

1) Borrowing Powers- Check Memorandum of Association and Articles of Association as regards borrowing powers of the directors/company and also examine compliance with section 179 and 180.

2) Register of Charges- The auditor should see that charges created have been duly registered and properly recorded in the register of charges. Proper disclosure of such charges has been made in the balance sheet.

3) Deposits-If the company has accepted any fixed deposits from the public then, the company must comply with provision of section 73 of Companies Act, 2013 and regulation / guidelines issued by Reserve Bank of India.

4) Outstanding Taxes, duties, etc- Any undisputed amount payable under income tax, wealth tax, custom duty, GST etc.

payable as on the Balance Sheet date, for a period of more than 6 months from the date they became payable should be properly reported

5) Group Loans- The auditor should examine that all loans taken from body corporate under the same management or from a company firm or other party in which any director is interested and determine whether in his opinion the rate of interests and other terms and conditions of the loans are prima facie not prejudiced to the interest of the company.

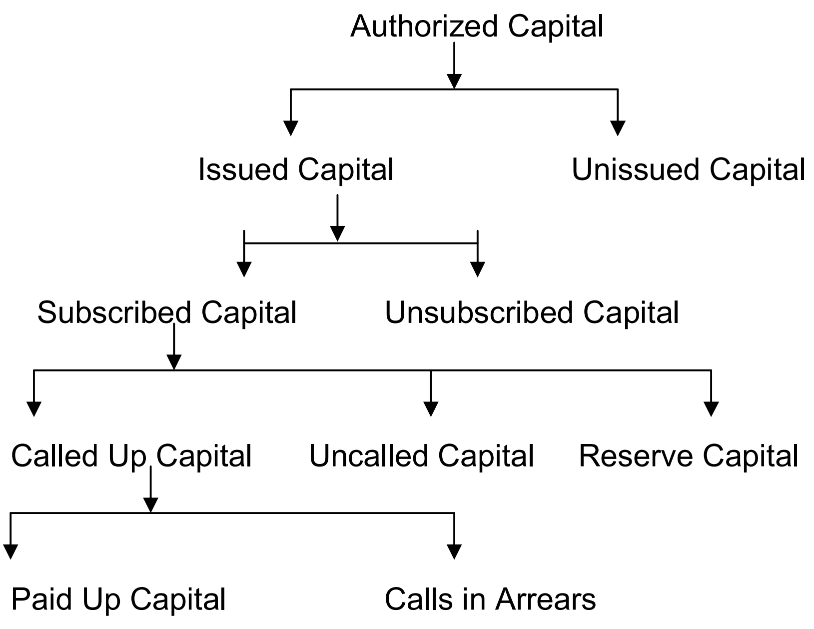
2.6 AUDIT OF SHARE CAPITAL

2.6.1 MEANING

Share capital means the capital raised by the issue of shares. it is the amount invested by the shareholders towards the face value of shares. Total amount invested by the shareholders is collectively known as share capital.

2.6.2 DIFFERENT ASPECTS OF SHARE CAPITAL

The following chart discloses the different aspects of Company's Share Capital.



Authorized Share Capital

Authorized share capital is the maximum that the company can raise during its lifetime. It is also called as the registered capital or nominal capital of the company. It is the maximum amount that the company can raise. It should be verified with reference to

i) Memorandum of Association in Capital clause for amount

ii) Articles of Association for its break-up in various class (i.e. equity & preference)

iii) Audited financial statements of the previous years.

Issued Capital

Issued capital is that part of authorized capital which is offered for subscription. It is calculated at nominal value i.e. face value.

It includes shares issued for cash, for consideration other than cash, bonus shares, rights shares.

Subscribed Capital

Subscribed capital is that part of the issued capital which has been subscribed or taken up by the public i.e. the capital which is allotted. Subscribed may be or may not be equal to issued capital, but it cannot be more than issued capital.

Called Up Capital

The company may not need the entire capital offered to be subscribed by the public. The company may therefore, decide to collect it in installments.

The called up capital is that portion of the subscribed capital which has been called or demanded by the company to be paid.

Paid up Capital

It is the part of called up capital which has been actually paid up by the members. There may be some members who may have not paid up the calls made. Paid up capital is equal to called up less calls in arrears.

2.6.3 TYPES OF SHARE CAPITAL

Accordingly to the Section 43, the capital of a limited company is divided into two categories

(a) equity share capital—

(i) with voting rights; or

(ii) with differential rights as to dividend, voting or otherwise in accordance with the prescribed rules; and

(b) preference share capital

1. Equity Share Capital

Section 43 defines (i) “equity share capital”, with reference to any company limited by shares, means all share capital which is not preference share capital;

2. Preference Share Capital

Section 43 defines "preference share capital" means that part of the issued share capital of the company which carries or would carry a preferential right with respect to—

(*a*) payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and

(*b*) repayment, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up.

2.6.4 AUDIT OF ISSUE OF SHARES FOR CASH

The companies Act and SEBI guidelines have laid down detailed legal provisions for various stages in issue of shares for cash. These stages are

a) Application Stage In this stage application of shares in received along with application money.

b) Allotment Stage Here allotment of shares is done, allotment letters are issued to successful applicants and allotment money is called for and received. Letters of regret are issued along with refund cheque to unsuccessful applicants.

c) Calls Calls are made and amount due is received.

- **Application Money Received**

1. Auditor should examine the resolution of board of directors and that of members approving the terms of issue of shares.

2. The auditor should examine original applicators for shares and check the entries in the application and allotment book with the help of these applications.

3. The auditor should check the entries in the application register and cross check with cash book and pass book for application money received.

4. He should also verify letter of regret issued to unsuccessful applicant along with refund of application money and cross verify cash book for the same.

5. He should verify the amount of over subscription and pro-rate allotment, as to what is done with excess application money received.

6. He should see that application money is not less than 5% of the face value.

- **Allotment of Shares**

1. The auditor should ensure that above legal requirements laid down by companies Act 2013 and other requirements of Articles of Association have been complied with.

2. The auditor should examine the resolution of the board of directors relating to allotment of shares.

3. He should see the copies of letter of allotment and letter of regret.

4. Auditor should sample check the entries in application and allotment book and verify the same with cash book for allotment money received.

5. He should check if money received on allotment has been transferred to share capital.

6. He should check the posting in the register of the amount received on allotment with the allotment book.

7. The auditor should also check relevant journal entries for excess amount received on application is properly adjusted on allotment.

- **Calls on shares**

1. Auditor should examine the resolution passed by the board as to making the calls from the minutes book.

2. Auditor should check the entries in the call book from the copies of the call letters, cash receipts and bank statement.

3. For calls in arrears, he should ensure that the amount is correctly calculated with reference to any excess (if any) received during allotment or application.

4. For calls in advance, the auditor should examine, if the amount is properly adjusted to calls. The articles should allow the company to receive calls in advance.

5. Auditor should also examine that interest on calls in advance is calculated with reference Articles or Table A.

6. Auditor should examine the calculation of interest or calls in arrears.

7. Auditor should also examine the amount with Bank Statement.

2.6.5 AUDIT OF SHARES ISSUED FOR CONSIDERATION OTHER THAN CASH

Company may issue shares for consideration other than cash. Such shares may be issued by the company towards payment of purchase consideration or towards payment of purchase of fixed assets, to promoters towards preliminary expenses incurred by them for bringing the company into legal existence to underwrite as underwriters commission.

- **Audit procedure to be adopted for the issue of shares for consideration other than cash**

1. The auditor should examine the prospectors for details of shares issued to promoters, its number and class and also for shares issued to underwriters as underwriting commission.

2. The auditor should examine the contracts with vendors, underwriters, promoters for the shares issued. The auditor should ascertain weather the consideration against which the shares are issued has been received in full. It helps to determine the terms and the nature of issue.

3. The auditor should examine the resolution of the board of directors relating to the allotment of shares.

4. The auditor should verify compliance with section 39 of the Companies Act.

5. The auditor should examine that proper journal entry is passed for share issued for consideration other than cash. He should also examine the posting and disclosure in Balance Sheet.

2.6.6 SHARES ISSUED AT PREMIUM

- **MEANING**

Section 52 of Companies Act, 2013, deals with issue of securities at a premium. Any amount, over and above the nominal value of shares received in cash or otherwise shall be credited to a separate account called as “Security Premium Account.”

- **Audit procedure to be followed for shares issued at premium**

1. The auditor should examine the prospectus for the rate of premium at which shares are issued.

2. The auditor should examine the Articles of Association to see whether they permit the issue of shares at a premium.

3. The auditor should examine the minutes of meetings of Board of directors and also verify the rate of premium.

4. The auditor should examine the legal provisions regarding the issue of shares at premium.

5. The auditor should examine that security premium is shown repeatedly on liability side of the Balance Sheet under the head “Reserve and Surplus.”

2.6.7 ISSUE OF SHARES AT DISCOUNT

- **MEANING**

When the shares are issued at a price less than the face value it is said to be issued at discount.

- **CONDITIONS**

According to section 53, **Prohibition on issue of shares at discount**

(*1*) Except as provided in section 54 (sweat equity shares), a company shall not issue shares at a discount.

(*2*) Any share issued by a company at a discounted price shall be void.

(*3*) Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

2.6.8 CALLS RECEIVED IN ADVANCE

- **MEANING**

A company, if authorized by its Articles of Association, accepts from its members the whole or a part of the amount remaining unpaid on any shares held by him, although call on such amount is not made. However, such an amount so received cannot be treated as part of the capital for the purpose of any voting rights.

Also according to Section 51, the company may, if so authorized by its Articles, pay dividend on calls in advance.

- **Audit procedure regarding calls in advance**

1. The auditor should examine the Articles of Association to see if it authorizes the acceptance of calls in advance. He should also see whether interest is payable on calls received in advance.

2. The auditor should also examine the prospectus for any information on calls in advance.
3. The auditor should examine the cash book for the amount received on calls in advance.
4. The auditor should obtain a list of all the members from whom calls in advance are received.
5. The auditor should verify that calls in advance are correctly credited to calls in advance and are not credited to share capital A/c.

2.6.9 CALLS IN ARREARS

- **MEANING**

An unpaid amount on calls is known as “Calls in Arrears.”

- **Audit Procedure for calls in arrears**

1. The auditor should examine the Articles Association for any interest chargeable on such arrears. If the Articles are silent or interest on calls on arrears then provisions in Table ’A’ are applicable. According to Table ‘A’ interest on calls in arrears should not exceed 5%.

2. The auditor should verify the amount of calls in arrear from statements and Cash Book for receipt of allotment and call money.

3. The auditor should obtain a list of member director from whom calls are in arrears.

4. The auditor should verify the journal entries of allotment and calls during which calls are in arrears. The amount should be crossed verified with cash book.

5. The auditor should examine that calls in arrears are properly shown on the liability side of Balance Sheet under the head, ‘share capital’. It should be deducted from the called up capital.

2.7 ISSUE OF BONUS SHARES

2.7.1 MEANING

The Articles of Association may authorize the company to capitalize profits or reserves and issue fully paid shares of a nominal value, equal to amount capitalized to the shareholders. Such an issue is called as “Bonus Issue” and shares are known as “Bonus Shares”.

2.7.2 Legal Provisions

(*1*) A company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of—

(*i*) its free reserves;

(*ii*) the securities premium account; or

(*iii*) the capital redemption reserve account

Provided that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

(*2*) No company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under sub-section (*1*), unless—

(*a*) it is authorised by its articles;

(*b*) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

(*c*) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(*d*) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

(*e*) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

(*f*) it complies with such conditions as may be prescribed.

(*3*) The bonus shares shall not be issued in lieu of dividend.

2.7.3 Audit Procedure

1. The auditor should examine that all the legal provisions relating to bonus issue are complied with

2. The auditor should examine the resolution passed by the directors in their board meeting. He should also examine the resolution passed by the shareholders at the general meeting approving the resolution passed by the directors.

3. The auditor should see that SEBI Guidelines relating to issue of bonus shares have been complied with.

4. The auditor should examine the register of members for bonus issue.

5. The auditor should examine the journal entries relating to bonus issue. Bonus issue should be added to share capital and should be covered in authorized share capital.

6. The auditor should examine the source from which bonus shares have been issued.

7. The audit should see that approval of the company law board of SEBI and the RBI have been obtained.

2.8 AUDIT OF FORFEITURE OF SHARES

2.8.1 MEANING

Sometimes shareholders fail to pay allotment money or any call thereafter on the day's fixed for payments. The directors may serve a notice to the defaulting member to pay the unpaid amount along with interest accrued. If even after such a notice, the shareholder fails to pay within the specified time, the directors may decide to forfeit the shares.

Articles of Association should authorize the board of directors to forfeit the shares.

2.8.2 Audit procedure for forfeiture of shares

1. The auditor should examine the provision of Articles relating to forfeiture of shares. If Articles are silent then regulation 29 to 34 of Table F are applicable for forfeiture of shares.

2. The auditor should see that proper notice had been given to the shareholders to pay the calls in arrears.

3. The auditors should examine the minutes of board meeting to verify that proper resolution for forfeiture of the shares is duly passed.

4. The auditor should verify the journal entry passed to check of share capital is correctly debited with called up amount and share forfeiture is added with paid up capital.

5. The shareholder should examine the Register of Members to check that their names are deleted from register and they are no longer in the list of members of the company.

6. The auditor should examine the share forfeiture account. If the shares cannot be re-issued, it should be disclosed in Balance Sheet on liability side under the head, 'Share Capital'.

7. The shares forfeited can be re-issued by board. The discount on re-issue should not exceed the paid up value of shares forfeited. The auditor should carefully audit these aspects.

2.9 REDEMPTION OF PREFERENCES SHARES

2.9.1 MEANING

Preference shares, as defined earlier, are those shares who have a preference in payment of dividend and repayment of capital on liquidation of the company.

According to the Companies Act, 2013, a company cannot issue irredeemable preference shares or recallable after the expiry of a period of 20 years from the date of its issue.

Section 55(2)prescribe the conditions for the redemption of preference shares.

2.9.2 Redemption of preference shares shall be subject to following conditions

1. Only fully paid up preference shares can be redeemed.

2. Shares can be redeemed either out of the proceeds of a fresh issue of shares made for the purpose of redemption or out of the profits that would otherwise be available for payment of dividends.

3. In case of redemption out of profit that would otherwise be available for dividend, an amount equivalent to the nominal value of preference shares redeemed must be transferred to "Capital Redemption Reserve (CRR)." CRR can be utilized for issuing fully paid bonus shares".

4. Premium, if any, on the redemption of preference shares can be provided either out of the securities premium account or out of the profit that can otherwise be available for distribution of dividend. Capital profit realized in cash can also be utilized for this purpose.

2.9.3 Audit procedure

1. The auditor should ensure that legal provisions of Section 55 have been complied with.

2. The auditor should examine that the issue and redemption of preference shares is authorized by the Articles of Association.

3. The auditor should verify that the money received on issue of preference shares and redemption of preference shares with that of cash book.

4. The auditor should examine the journal entries and see that Capital Redemption Reserve is correctly created with the amount of profit which would otherwise be available for dividend in case redemption is done out of such profits.

5. The auditor should examine the minutes of meeting to check that proper resolution is passed by the Board of Directors.

2.10 AUDIT OF SHARE TRANSFER

Shares are transferred from one person to another and such transfer is to be notified through the company.

2.10.1 Audit Procedure

1. The auditor should examine the A/A and find out the procedure for transfer of shares.
2. The transfer form should be scrutinized in respect of the following

i) It should be complete, properly signed, dated in the prescribed format, properly stamped, and presented to the company in time.

ii) The details of the transfer form should be checked with the entries in the share Register.

2.10.2 Before approval of Transfer

The auditor should check that:

1. The transfer fees must be deposited in a scheduled bank.
2. The auditor should ensure that notice is sent to the transferor and no objection is received from them.
3. In case of transfer of partly paid up shares, notice should be sent to the transferee and if there is no objection should be received within two weeks from the date of service of notice.

2.10.3 Approval of transfer

1. The auditor should examine the minute book of director's meeting and see that the transfer has been sanctioned.

2. If the transfer is to a limited company, the auditor should examine the A/A and see that the company is allowed to invest in the shares.

3. The auditor should check that the transferee has not incurred any disqualification to become a member.

4. In case the share certificate is not available the letter of indemnity should be examined.

2.11 BUY-BACK OF SHARES

2.11.1 Procedure

Buy-back means purchase by a company of its own securities. Auditor should keep in mind the following points while examining this item

a) **Legal Provisions –** The buy-back should be in accordance with **Section 68** of the Companies Act, 2013

b) Securities – A company may buy-back its own shares or other specified securities, which includes employee stock options or any other security notified by the Central Government from time to time.

c) Sources of Funds – A company can purchase its securities only from out of its free reserves or its securities premium account (including share premium account) or the proceeds of an earlier issue of shares other than fresh issue made specifically for buy-back purpose.

d) Authorized by A/A – The buy-back should be authorized by the Articles of Association.

e) Authorized by special resolution – The buy-back should be authorized by passing a special resolution in a general meeting of the shareholders of the company.

f) Limit on amount – The amount of buy-back should not exceed 25% of the total paid up capital and free reserves of the company.

g) Debt-equity ratio – The debt-equity ratio after the buy-back should not exceed 21.

h) Fully paid-up shares – The shares of the company subject to buy back must be fully paid-up.

i) Regulations of SEBI – The buy-back must be in accordance with the regulations made in this regard by the Securities Exchange Board of India (SEBI).

j) Explanatory Statement – The explanatory statement sent along with the notice of the meeting at which the special resolution allowing buy-back is proposed to be passed should contain the following details (i) A full and complete disclosure of all material facts; (ii) The necessity for buy-back; (iii) the class of security intended to be purchased; (iv) the amount to be invested under buy-back; (v) The time-limit for completion of the process of buy-back;

k) Time limit for completion – Buy-back should be completed within twelve months from the date of passing the special resolution.

l) Method – Buy-back can be done by any of the following methods (i) From the existing security-holders on a proportionate basis; (ii) From the open market; (iii) From odd lots (i.e., lots smaller than the market lots); (iv) From the securities issued under schemes for employees stock option or sweat equity.

m) Declaration of solvency – Before making any purchase, the board of directors should file a declaration of solvency in the prescribed form with the Registrar of Companies (ROC) and the Securities Exchange Board of India (SEBI). The declaration shall affirm that the board of directors have made a full inquiry into the affairs of the company and that the company is fully capable of meeting its liability and will not become insolvent within one year. The declaration shall be signed by two directors, one of whom must be the managing director, if any. The declaration need not be filed with SEBI in the case of a company whose shares not listed on any recognized stock exchange.

n) Return – After buy-back the company should file a Return in the prescribed form with the ROC and the SEBI, within 30 days of the completion of the buy-back.

o) Register of buy-back – The Company should keep a register of securities bought, the price paid, the data of cancellation of such securities and other prescribed details.

p) Destroy Securities after buy-back – After the buy-back, the company should extinguish and physically destroy the securities so bought back, within 7 days of the completion of the buy-back.

q) NO further issue after buy-back – A company shall not make a further issue of securities within 24 months from the buy-back, except by way of bonus shares or in order to comply with the terms of issue of existing securities by way of conversion of share warrants, stock option schemes, sweat equity or conversion of preference shares/debentures into equity.

r) Buy-back prohibited – Buy-back is prohibited under the following circumstances (i) Through any subsidiary companies including the company's subsidiaries; (ii) Through any investment company or group of investment companies; (iii) A subsisting default in repayment or redemption of deposit, debentures, preference shares or term loan to any financial institution or bank.

2.11.2 Auditor's Duties

a) **Legal procedures –** Auditor should check compliance with the above legal procedures under Section 68, 69 and 70 of Companies Act, 2013 and Rule 17 of Companies (Share Capital and Debentures) Rules, 2014 ; and for Listed companies Section 68, 69 and 70 of Companies Act, 2013;

- Rule 17 of Companies (Share Capital and Debentures) Rules, 2014 and
- Securities and Exchange Board of India (Buy-back of Securities) Regulations, 1998 and Securities and Exchange Board of India (Buy-back of Securities) (Amendment) Regulations, 2013.

b) Authorization of amount used for buy-back – The auditor should verify particularly that the funds employed for the buy-back are from the resources as permitted by the law.

c) Reconciliation of amount paid for buy-back – The reconciliation of entries in escrow account or the bank account separately opened for payment of purchase consideration have to be verified with the number of shares bought back and price paid.

d) Reconciliation of number for shares bought back – The auditor should also verify the entries made in the concerned books/registers with regard to destruction of share certificates and extinguishments of dematerialized shares and a reconciliation of these two to arrive at the total number of securities purchased under buy-back process.

2.12 ALTERATION OF SHARE CAPITAL

2.12.1MEANING

Section 2(46) of the Companies Act, 2013, deals with the power of a limited company to alter its share capital. If authorized by its Articles, a Limited Company can alter its share capital. It means it can increase, consolidate, or divide or split its shares, convert shares into stock and vice versa. It can also cancel the unissued shares.

2.12.2 AUDITOR'S DUTIES

The Auditor should

i) Verify the Articles to confirm whether the company is authorized to alter the share capital.

ii) See that the provision of the Articles and Section 61 except proviso to clause (b) of sub-section (1) and Section 64 are compiled with.

iii) Verify the minutes of the meeting of directors and the minutes of the shareholders authorizing the alteration.

iv) Verify the entries in the books of accounts, the register of members and other register.

v) See that notice is given to Registrar of Companies and that the Registrar has altered the Memorandum or the Articles of both.

vi) Compare the cancelled share certificates with the counterfoils of the new certificates issued.

2.13 SWEAT EQUITY SHARES

2.13.1 MEANING

Sweat equity means equity shares issued by the company to its employees or directors at a discount or for consideration other than cash. Such shares may be issued for providing know-how or for making available property rights or value additions.

2.13.2 CONDITIONS

1) Not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business;

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

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

4) The special resolution authorising the issue of sweat equity shares shall be valid for making the allotment within a period of not more than twelve months from the date of passing of the special resolution.

5) The sweat equity shares issued to directors or employees shall be locked in/non transferable for a period of three years from the date of allotment and the fact that the share certificates are under lock-in and the period of expiry of lock in shall be stamped in bold or mentioned in any other prominent manner on the share certificate.

6) Where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the

sweat equity shares are issued in accordance with the Companies (Share Capital and Debentures) Rules, 2014.

2.14 AUDIT OF DEBENTURES

2.14.1 Meaning

Debenture is written acknowledgement under the seal of a company, of a debt due. It also contains the provisions as to payment of interest and repayment of capital. The debentures may be of following types

a) Simple or naked
b) Fixed or floating charge
c) First mortgage or second mortgage
d) Convertible or Non-convertible

2.14.2 Audit Procedure for issue of Debentures

The auditor should take following steps for the audit of allotment of debentures.

i) The auditor should examine Articles of Association to verify that the company has power to borrow funds through issue of debentures.

ii) The auditor should examine that relevant resolutions are passed by the directors and the shareholders and guidelines of SEBI are followed.

iii) The auditor should see whether prospectus or a statement in lieu of prospectus has been filed with the Registrar of Companies.

iv) The auditor should verify that an application is made to one or more recognized stock exchanges before the offer of debentures to the public for subscription by the issue of a prospectus.

v) The auditor should examine the powers of directors whether there is any restriction under Section 180.

vi) Section 71 except sub-sections (9) to (11) has now made it compulsory for filing of debenture trust deed. The trust deed shall be open for inspection and can be made available on payment.

vii) Section 71 except sub-sections (9) to (11) has made it compulsory for creation of Debenture Redemption Reserve. Such an amount cannot be utilized for any other purpose except for redemption of debentures.

viii) If the debentures are secured by charge on any assets, then the auditor should verify that the charge is registered with the

Registrar and such a charge is also recorded in the separate register to maintain the details of such charges.

ix) The auditor should examine the entries in the counterfoils of debentures issued with the debenture register.

x) The auditor should also examine the journal entries for application and allotment and also verify that if it is posted correctly and verify the same with debenture register.

2.14.3 DEBENTURES ISSUED AT DISCOUNT

- **MEANING**

When debentures are issued at a price less than it's nominal value, debentures are said to be issued at discount. Section 40 lays down the provisions for issue of debentures at a discount.

- **Audit Procedure**

i) The auditor should examine the Articles of Association to verify that it authorizes the issue of debentures at discount.

ii) The auditor should examine the minutes of board meeting to verify the resolution passed by the board for issue at discount.

iii) The auditor should examine that the interest is payable on nominal value even if shares are issued at discount.

iv) The auditor should examine the journal entries to see if the discount is debited to "Discount on Issue" A/c and not to Profit & Loss A/c.

v) The discount should be written off proportionately to the amount utilized. The writing off should not be for years more than the tenure of debentures.

2.14.4 DEBENTURES ISSUED AT PREMIUM

- **MEANING**

When debentures are issued at the price in excess of its nominal value then the debentures are said to be issued at premium. The company can issue debentures at a premium.

- **Audit Procedure**

i) The auditor should examine the Articles to verify whether debentures can be issued at premium.

ii) The auditor should examine the minutes of Board Meeting to verify that the resolution to issue debentures is passed.

iii) Interest should be payable on nominal value of debenture and not at issue price.

iv) The auditor should examine the journal entry to verify that premium on issue has been credited to securities premium account and not credited to Profit & Loss Account.

v) The auditor should examine that security premium has been disclosed under the head “Reserves and Surplus” on the liability side of the Balance Sheet.

vi) The premium so collected can be utilized for writing off debenture issue expenses, for redemption of debentures of for writing off preliminary expenses.

2.14.5 REDEMPTION OF DEBENTURES

The debentures can be redeemed at par or at premium.

The premium payable on redemption can be provided in either of the following ways

i) The premium payable on redemption may be debited to “Loss on Issue A/c” on the date of issue itself. Such a loss should be disclosed in Balance Sheet on asset side. It should be carried forward and should be written off in proportion to the amount utilized every year. It should be written off over the tenure of the debenture.

ii) The second option is to write off the premium on redemption to profit and loss account in the year the debentures are redeemed.

- **Audit Procedure**

i) The auditor should examine the Articles for the provisions for redemption of debentures.

ii) The auditor should examine the minute book for the resolution passed in Board Meeting authorizing redemption of debentures.

iii) The auditor should verify the journal entries and also see that they are properly posted.

2.14.6 INTEREST ON DEBENTURES

Debentures are instruments of debt. A fixed rate of interest is payable on such instrument. Interest payment is a charge against income.

i) Payment of interest is revenue expenditure. It should be paid even if there is no profit.

ii) The auditor should examine the journal entry and verify that interest is transferred to Profit & Loss A/c.

iii) The auditor should examine Bank statement for the payment made to debenture holders towards interest.

iv) Interest paid on debentures should be disclosed as a separate item in Profit & Loss Statement.

iv) The auditor should examine the Articles for the provisions for redemption of debentures.

2.14.7 ISSUE OF DEBENTURES AS COLLATERAL SECURITY

- **MEANING**

The debentures can be issued as a collateral security for any loan obtained from financial institutions, or banks or creditors or other parties.

Collateral security means security given which can be realized by the party to whom such security is issued or is holding, in the event if the original loan is not repaid on specified time according to the agreement between the parties.

The amount is issued as loan and not against debentures issued as collateral security. The amount of debentures issued may be more than or less than the amount of loan. When the loan is repaid, the security is taken back and extinguished. The security can be sold if the loan is not paid on time.

- **Audit Procedure**

i) The auditor should examine the loan agreement and verify the amount of collateral security to be issued.

ii) The auditor should examine that the loan amount has been received by the company and is properly accounted for.

iii) The auditor should examine that issue of debentures as collateral security is entered in register of mortgages.

iv) The auditor should see that the Registrar of Companies is intimated for registration of charge. When the loan is repaid the satisfaction of the charge should be informed to the Registrar of Companies.

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3

THE COMPANY AUDIT II

Unit Structure

3.0 OBJECTIVES

After studying the unit the students will be able:

- To explain the Schedule III
- Distinguish between old schedule VI and Schedule III

3.1 INTRODUCTION TO SCHEDULE III

Every company registered under the Act shall prepare its Balance Sheet, Statement of Profit and Loss and notes thereto in accordance with the manner prescribed in Schedule III to the Companies Act, 2013.

Government has made the revised Schedule III applicable to all companies. The requirements of the Revised Schedule III however, do not apply to companies as referred to in the provision to Section 129 of the Act, i.e. any insurance or banking company,, or any company engaged in the generation or supply of electricity or to any other class of company for which a form of Balance Sheet and Profit & Loss account has been specified in or under any other Act governing such class of company.

3.2 KEY FEATURES OF REVISED SCHEDULE III – BALANCE SHEET

• The revised schedule contains General Instructions. Part I – Form of Balance Sheet; General Instruction for Preparation of Balance Sheet, Part II – Form of Statement of Profit & Loss;

General Instructions for Preparation of Statement of Profit & Loss; General Instructions for preparation of Consolidated Financial Statements,

• The Revised Schedule III has eliminated the concept of 'schedule' and such information is now to be furnished in the notes to accounts.

• The Revised Schedule gives prominence to Accounting Standards (AS) i.e. in case of any conflict between the AS and the Schedule, AS shall prevail.

• The revised schedule prescribes a vertical format for presentation of balance sheet therefore, no option to prepare the financial statement in horizontal format. It ensures application of uniform format.

• All assets and liabilities classified into current and non-current and presented separately on the face of the Balance Sheet.

• Number of shares held by each shareholder holding more than 5% shares now needs to be disclosed.

• Details pertaining to aggregate number and class of shares allotted for consideration other than cash, bonus shares.

• Any debit balance in the Statement of Profit and Loss will be disclosed under the head "Reserves and Surplus." Earlier, any debit balance in Profit & Loss Account carried forward after deduction from uncommitted reserves was required to be shown as the last item on the asset side of the Balance Sheet.

• Specific disclosures are prescribed for Share Application money. The application money not exceeding the capital offered for issuance and to the extent not refundable will be shown separately on the face of the Balance Sheet. The amount in excess of subscription or if the requirements of minimum subscription are not met will be shown under "Other current liabilities".

• The term "sundry debtors" has been replaced with the term "trade receivables." 'Trade receivables' are defined as dues arising only from goods sold or services rendered in the normal course of business. Hence, amounts due on account of other contractual obligation can no longer be included in the trade receivables.

• The Old Schedule VI required separate presentation of debtors outstanding for a period exceeding six months based on date on which the bill/invoice was raised whereas, the Schedule III requires separate disclosure of "trade receivables outstanding for a period exceeding six months from the date the bill/invoice is due for payment."

• "Capital advances" are specifically required to be presented separately under the head "Loans & Advances" rather than including elsewhere.

• Tangible assets under lease are required to be separately specified under each class of asset. In the absence of any further clarification, the term "under lease" should be taken to mean assets given on operating lease in the case of lesser and assets held under finance lease in the case of lessee.

• In the Old Schedule VI, details of only capital commitments were required to be disclosed. Under the Schedule III, other commitments also need to be disclosed.

3.3 KEY FEATURES OF SCHEDULE III – STATEMENT OF PROFIT & LOSS

• The name has been changed to "Statement of Profit & loss" against 'Profit & Loss account' as contained in the Old Schedule VI.

• Unlike the Old Schedule VI, Schedule III lays down a format for the presentation of Statement of Profit and Loss. This format of Statement of Profit and Loss does not mention any appropriation item on its face. Further, the Schedule III format prescribes such 'below the line' adjustment to be presented under "Reserves and Surplus" in the Balance Sheet.

• As per Schedule III, any item of income or expense which exceeds one per cent of the revenue from operations or Rs. 1,00,000 (earlier 1% of total revenue or Rs.5,000), whichever is higher, needs to be disclosed separately.

• In respect of companies other than finance companies, revenue from operations need to be disclosed separately as revenue from (a) sale of products, (b) sale of services and (c) other operating revenues.

• Net exchange gain/loss on foreign currency borrowings to the extent considered as an adjustment to interest cost needs to be disclosed separately as finance cost.

• Break-up in terms of quantitative disclosures for significant items of statement of profit & loss, such as raw material consumption, stocks, purchases and sales have been to be decided based on materiality and presentation of true and fair view of the financial statements.

3.4 COMPARITIVE ANALYSIS BETWEEN OLD SCHEDULE VI AND SCHEDULE III

PARTICULARS	OLD SCHEDULE VI	SCHEDULE III
Parts	Part I (Balance Sheet), Part II (Profit and Loss Account), Part III(Interpretation) and Part IV (Balance Sheet abstract of company's general business profile)	Only two parts – Part I (Balance Sheet) and Part II (Statement of Profit and Loss) Part III (Interpretation) and Part IV (Balance sheet Abstract of Company's general business profile) omitted.
Format of Balance Sheet	Horizontal and Vertical formats are prescribed.	Only vertical format is prescribed.
Rounding off (R/Off) of Figures appearing in financial statement	(a) Turning of less than Rs. 100 Crs – R/off to the nearest Hundreds, thousands or decimal thereof (b) Turnover of Rs. 100 Crs or more but less than Rs. 500 Crs – R/off to the nearest Hundreds, thousands, lakhs or millions or decimal thereof (c) Turnover of Rs. 500 Crs or more – R/off to the nearest Hundreds, thousands, lakhs, millions or crores, or decimal thereof	(a) Turnover of less than Rs. 100 Crs – R/off to the nearest Hundreds, thousands, lakhs or millions or decimal thereof (b) Turnover of Rs. 100 Crs or more – R/off to the nearest lakhs, millions or crores,or decimal thereof.
Net Working Capital	Current assets & liabilities are shown together under application of funds. The net working capital appears on balance sheet	Assets & Liabilities are to be bifurcated into current & non-current and to be shown separately. Hence, net working capital will not be appearing on Balance Sheet
Fixed Assets	There was no bifurcation required into tangible & intangible assets.	Fixed assets to be shown under non-current assets and it has to be bifurcated in to Tangible & Intangible assets.
Borrowings	Short term & long term borrowings are grouped together under the head Loan funds sub-head Secured/Unsecured	Long term borrowing to be shown under non-current liabilities and short term borrowings to be shown under current liabilities with separate disclosure of secured/ unsecured loans.

Finance lease obligation	Finance lease obligations are included in current liabilities	Finance lease obligations are to be grouped under the head non-current liabilities
Deposits	Lease deposits are part of loans & advances	Lease deposits to be disclosed as long term loans & advances under the head non-current assets
Investments	Both current & non-current investments to be disclosed under the head investments	Current and non-current investments are to be disclosed separately under current assets & non-current assets respectively
Loans & Advances	Loans & Advance are disclosed along with current assets	Loans & Advances to be broken up in long term & short term and to be disclosed under non-current & current assets respectively.
Deferred Tax Assets/ Liabilities	Deferred Tax assets/liabilities to be disclosed separately	Deferred Tax assets/ liabilities to be disclosed under non-current assets/ liabilities as the case may be.
Cash & Bank Balances	Bank balance to be bifurcated in scheduled banks & others	Bank balances in relation to earmarked balances, held as margin money against borrowings, deposits with more than 12 months maturity, each of these to be shown separately.
Profit & loss (Dr. Balance)	P & L debit balance to be shown under the head Miscellaneous expenditure & losses	Debit balance of Profit & Loss Account to be shown as negative figure under the head Surplus. Therefore, reserve & surplus balance can be negative.
Sundry Creditors	Creditors to be broken up in to micro & small suppliers and other creditors	It is named as Trade payables and there is no mention of micro & small enterprise disclosure.
Other current liabilities	No specific mention for separate disclosure of Current maturities of finance lease obligation	Current liabilities of long term debt to be disclosed under other current liabilities. Current maturities of finance leas obligation to be disclosed.
Separate line item Disclosure criteria	Any item under which expense exceeds one per cent of the total revenue of the company or Rs. 5,000 whichever is higher; shall be disclosed separately	Any item of income/expense which exceeds one per cent of the revenue from operations or Rs. 1,00,000, whichever is higher; to be disclosed separately

Expense Classification	Function wise & nature wise	Expenses in Statement of profit and loss to be classified based on nature of expenses
Finance cost	Finance cost to be classified in fixed loans & other loans	Finance cost shall be classified as interest expense, other borrowing costs & Gain/loss on foreign currency transaction & translation

3.5 FORMAT OF SCHEDULE III

The Ministry of Corporate Affairs specified the format of Schedule III as follows:

A. General Instructions
B. Part I – Form of Balance Sheet
C. General Instruction for Preparation of Balance Sheet
D. Part II – Form of Statement of Profit and Loss
E. General Instructions for Preparation of Statement of Profit and Loss
F. General Instructions for the Preparation of Consolidated Financial Statements

A. General Instructions

1. Where compliance with the requirements of the Act, including the Accounting Standards as applicable to companies, requires any change in treatment or disclosure including addition, amendment, substitution or deletion in the head/sub-head or any changes inter se, in the financial statements or statements forming part thereof, the same shall be made and the requirements of the Schedule III shall stand modified accordingly.

2. The disclosure requirements specified in Parts I and II of this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 1956. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act, 2013 shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

3. Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required:
a) Narrative descriptions or disaggregation of items recognized in those statements and

b) Information about items that do not qualify for recognition in those statements.

Each item on the face of the Balance Sheet and the Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts. In preparing the Financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and not providing important information as a result of too much aggregation.

4. Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as below:

Turnover Rounding Off	
(i) less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(ii) one hundred crore rupees or more	To the nearest lakhs, millions or crores, or decimals thereof.
(iii) Once a unit of measurement is used, it should be used uniformly in the Financial Statements	

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

6. For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.

B. Part I: Form of Balance Sheet

Name of the Company…………………….
Balance Sheet as at ………………………
(Rupees in…………)

Particulars	**Note No.**	**Figures as at the end of current reporting period**	**Figures as at the end of previous reporting period**
1	**2**	**3**	**4**
I. EQUITY AND LIABILITIES			
(1) Shareholders' funds			
(a) Share capital			
(b) Reserves and surplus			
(c) Money received against share warrants			

(2) Share application money pending allotment **(3) Non-current liabilities** (a) Long-term borrowings (b) Deferred tax liabilities (Net) (c) Other Long term liabilities (d) Long-term provisions **(4) Current liabilities** (a) Short-term borrowings (b) Trade payables (c) Other current liabilities (d) Short-term provisions **TOTAL** **II. ASSETS** **Non-current assets** (1) (a) Fixed assets (i) Tangible assets (ii) Intangible assets (iii) Capital work-in-progress (iv) Intangible assets under development (b) Non-current investments (c) Deferred tax assets (net) (d) Long-term loans and advances (e) Other non-current assets **(2) Current assets** (a) Current investments (b) Inventories (c) Trade receivables (d) Cash and cash equivalents (e) Short-term loans and advances (f) Other current assets			
TOTAL			

C. General Instructions for Preparation of Balance Sheet

1. An asset shall be classified as current when it satisfies any of the followings criteria:

(a) it is expected to be realized in or is intended for sale or consumption in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is expected to be realized within twelve months after the reporting date; or

(d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date:

All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have duration of 12 months.

3. A liability shall be classified as current when it satisfies any of the following criteria:

(a) It is expected to be settled in the company's normal operating cycle;

(b) It is held primarily for the purpose of being traded;

(c) It is due to be settled within twelve months after the reporting date; or

(d) The company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivables shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A company shall disclose the following in Notes to Accounts:

6A. **Share Capital**

Clauses (a) to (i) of notes 6A deal with disclosures for Share Capital and such disclosures are required for each class of share capital (different classes of preference share to be treated separately).

a. The number and amount of shares authorized.

b. The number of shares issued, subscribed and fully paid, and subscribed but not fully paid

c. Par value per share

d. A reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period

e. The rights, preferences and restriction attaching to each class of shares including restriction on the distribution of dividends and the repayment of capital.

f. Shares in respect of each class in the company held by its holding capacity or its ultimate holding company or the ultimate holding company in aggregate

g. Shares in the company held by each.

h. Shareholders holding more than 5 per cent shares specifying the number of shares held

i. Shares reserved for issue under options and contracts/ commitments for the sale of shares/disinvestments, including the terms and amounts.

j. For the period of five years immediately preceding the date as at which the balance sheet is prepared:

i. Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash
.
ii. Aggregate number and class of shares allotted as fully paid up by way of bonus shares.

iii. Aggregate number and class of shares bought back.

k. Terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date

l. Calls unpaid (showing aggregate value of calls unpaid by directors and officers)

6B. **Reserves and Surplus**
(i) Reserve and surplus shall classified as follows
a) Capital Reserves
b) Capital Redemption Reserve
c) Securities Premium Reserve
d) Debenture Redemption Reserve
e) Revaluation Reserve
f) Share Options Outstanding Account
g) Other Reserves (Specify the nature and purpose of reserve and the amount in respect thereof)

h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc.

(Additions and deductions since the last Balance Sheet to be shown under each of the specified head)

(ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

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

6C. Non-Current Liabilities

a. Long-term borrowings:

- Long-term borrowings shall be classified as:
  (a) Bonds/debentures;
  (b) Term Loans;
- From banks;
- From other parties

  (c) Deferred payment liabilities;
  (d) Deposits;
  (e) Loans and advances from related parties;
  (f) Long term maturities of finance lease obligations;
  (g) Other loans and advances (specify nature).

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

• Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed. The word "others" used in the phrase "directors or others" would mean any person or entity other than a director.

• Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by installments, the date of maturity for this purpose must be reckoned as the date on which the first installment becomes due.

• Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed.

• Period and amount of continuing default as on the Balance Sheet data in repayment of loans and interest shall be specified separately in each case.

b. Other Long-term liabilities

This should be classified into:

a) Trade payables; and

b) Others.

c. Long-term Provisions

This should be classified into

a) Provision for employee benefits and

b) Others specifying the nature.

6D. Current Liabilities

a. Short-term borrowings;

(i) (a) Loans repayable on demand

- From banks;
- From other parties.

(b) Loans and advances from related parties;

(c) Deposits;

(d) Other loans and advances (specify nature)

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

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

(iv) Period and amount of default as on the Balance Sheet date in repayment of loans and interest shall be specified separately in each case.

b. Other current liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease of obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends;

(g) Application money received for allotment of securities and due for refund and interest accrued thereon;

(h) Unpaid matured deposits and interest accrued thereon;

(i) Unpaid matured debentures and interest accrued thereon;

(j) Other payables (specify nature)

The portion of long term debts/lease obligation, which is due for payments within twelve months of the reporting date is required to be classified under “Other Current Liabilities” while the balance amount should be classified under Long-term Borrowings. Other Payables would include amounts in the nature of statutory dues such as Withholding taxes, GST etc.

c. Short-term provisions
The amounts shall be classified as:
(a) Provision for employee benefits;
(b) Others (Specify nature).

6E. Non-Current Assets

a. Tangible assets
(i) Classification shall be given as:
(a) Land.
(b) Buildings.
(c) Plant and Equipment
(d) Furniture and Fixtures
(e) Vehicles.
(f) Office Equipment
(g) Others (Specify nature).

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

(III) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of thereporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

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

b. Intangible assets
(i) Classification shall be given as:
(a) Goodwill.
(b) Brands/trademarks.
(c) Computer software.
(d) Mastheads and publishing titles.
(e) Mining rights.
(f) Copyrights, and patents and other intellectual propertyrights, services and operating rights.

(g) Recipes, formulae, models, designs and prototypes.
(h) Licenses and franchise.
(i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

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

c. Non-current investments
(i) Non-current investments shall be classified as trade investments and other investments and further classified as:
(a) Investment property;
(b) Investments in Equity Instruments;
(c) Investments in preference shares
(d) Investments in Government or trust securities;
(e) Investments in debentures or bonds;
(f) Investments in Mutual Funds;
(g) Investments in partnership firms;
(h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (III) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly paid).

In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(III) The following shall also be disclosed:
(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;
(c) Aggregate provision for diminution in value of investments

d. Long-term loans and advances
(i) Long-term loans and advances shall be classified as:
(a) Capital Advances;
(b) Security Deposits;
(c) Loans and advances to related parties (giving details thereof);
(d) Other loans and advances (specify nature).

(ii) The above shall also be separately sub-classified as:
(a) Secured, considered good;
(b) Unsecured, considered good;
(c) Doubtful.

(III) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company of any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

6F. Current Investment

a. Current Investments
(i) Current Investments shall be classified as:
(a) Investments in Equity Instruments;
(b) Investment in Preference Shares
(c) Investments in government or trust securities;
(d) Investments in debentures or bonds;
(e) Investments in Mutual Funds;
(f) Investments in partnership firms
(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (III) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly paid).

(ii) The following shall also be disclosed:
(a) The basis of valuation of individual investments
(b) Aggregate amount of quoted investments and market value thereof;
(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

b. Inventories

(i) Inventories shall be classified as:
(a) Raw materials;
(b) Work-in-progress;
(c) Finished goods;
(d) Stock-in-trade (in respect of goods acquired for trading);
(e) Stores and spares;
(f) Loose tools;
(g) Others (specify nature)
(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories. Mode of valuation shall be stated.

c. Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for period exceeding six months from the date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:
(a) Secured, considered goods:
(b) Unsecured considered goods;
(c) Doubtful.
(III) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

d. Cash and Cash Equivalents

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

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

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

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

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

e. Short-term loans and advances
(i) Short-term loans and advances shall be classified as:
(a) Loans and advances to related parties (giving details thereof);
(b) Others (specify nature).

(ii) The above shall also be sub-classified as:
(a) Secured, considered good;
(b) Unsecured, considered good;
(c) Doubtful.

(III) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

f. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

6G. Contingent liabilities and commitments (to the extent not provided for)
(i) Contingent liabilities shall be classified as:
(a) Claims against the company not acknowledged as debt;
(b) Guarantees;
(c) Other money for which the company is contingently liable

6H. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.

6I. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of a note as to how such unutilized amounts have been used or invested.

6J. If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

D. Part II – Form of Statement of Profit and Loss

Name of the Company…………………….

Profit and loss statement for the year ended ………………………

(Rupees in…………)

	Particulars	**Note No.**	**Figures as at the end of current reporting period**	**Figures as at the end of the previous reporting period**
	1	**2**	**3**	**4**
I	Revenue from operations			
II	Other income			
III	**Total Revenue (I + II)**			
IV	**Expenses:**			
	Cost of materials consumed			
	Purchases of Stock-in-Trade			
	Changes in inventories of finished goods work-in-progress and Stock-in-Trade			
	Employee benefits expense			
	Finance costs			
	Depreciation and amortization expense			
	Other expenses			
	Total expenses			
V	**Profit before exceptional and extraordinary items and tax (III - IV)**			
VI	Exceptional items			
VII	**Profit before extraordinary items and tax (V - VI)**			
VIII	Extraordinary items			

IX	**Profit before tax (VII- VIII)**			
X	Tax expense: (1) Current tax (2) Deferred tax			
XI	Profit (Loss) for the period from continuing operations (VII-VIII)			
XII	Profit/(loss) from discontinuing operations			
XIII	Tax expense of discontinuing operations			
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)			
XV	**Profit (Loss) for the period (XI + XIV)**			
XVI	**Earnings per equity share:** *(1) Basic* *(2) Diluted*			

E. General Instructions for Preparation of Statement of Profit and loss

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-section (2) of Section 210 of the Act, in like manner as they apply to a statement of profit and loss.

2. (A) In respect of a company other than finance company revenue from operations shall disclose separately in the notes revenue from
(a) Sale of products;
(b) Sale of services;
(c) Other operating revenues;
Less:
(d) Excise duty

(B) In respect of a finance company, revenue from operations shall include revenue from
(a) Interest; and
(b) Other financial services

Revenue under each of the above heads shall be disclosed separately by way of Notes to Accounts to the extent applicable.

3. Finance Costs: Finance costs shall be classified as:
(a) Interest expense;
(b) Other borrowing costs;
(c) Applicable net gain/loss on foreign currency transactions and translation

4. Other Income: Other income shall be classified as:
(a) Interest income (in case of a company other than a finance company);
(b) Dividend Income;
(c) Net gain/loss on sale of investments
(d) Other non-operating income (net of expenses directly attributable to such income).

5. Additional Information:

(i)A company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:-

(a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (III) expense on Employee Stock Option Scheme(ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].

(b) Depreciation and amortization expense;

(c) Any item of income or expenditure which exceeds 1% of the revenue from operations or Rs. 1,00,000, whichever is higher;

(d) Interest Income;

(e) Interest Expense;

(f) Dividend Income;

(g) Net gain/loss on sale of investments;

(h) Adjustments to the carrying amount of investments;

(i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

(j) Payments to the auditor as (a) auditor, (b) for taxation matters, (c) for company law matters, (d) for management services, (e) for other services, (f) for reimbursement of expenses; (k) Details of items of exceptional and extraordinary nature;

(l) Prior period items;

(ii) (a) In the case of manufacturing companies,-
(1) Raw material under broad heads.
(2) Goods purchased under broad heads.
(b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.

(c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

(e) In the case of other companies, gross income derived under broad heads.

(iii) In the case of concerns having works in progress, works-in-progress under broad heads.

(iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance-sheet ismade up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(v) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as longer required.

(vi) Expenditure incurred on each of the following items, separately for each item:-
(a) Consumption of stores and spare parts.
(b) Power and fuel.
(c) Rent.
(d) Repairs to buildings.
(e) Repairs to machinery.
(f)Insurance.
(g) Rates and taxes, excluding, taxes on income.
(h) Miscellaneous expenses.

(vii) (a) Dividends from subsidiary companies.
(b) Provisions for losses of subsidiary companies.

(viii) The profit and loss account shall also contain by way of a note the following information, namely:-

a) Value of imports calculated on C.I.F. basis by the company during the financial year in respect of –
I. Raw Materials
II. Components and spare parts
III. Capital goods;

b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;

c) Total value if all imported raw material, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

d) The amount remitted during the year in foreign currencieson account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

e) Earnings in foreign exchange classified under the following heads, namely:-
I. Export of goods calculated on F.O.B. basis;
II. Royalty, know-how, professional and consultation fees;
III. Interest and dividend;
IV. Other income, indicating the nature thereof.

3.6 QUESTIONS ON THE COMPANY AUDIT PART I AND PART II

A. Descriptive Questions

1. What are the general considerations in a company audit?
2. Explain pre-commencement considerations of a company audit.
3. Explain how to verify Managerial Remuneration.
4. Explain how to verify Charity and Donations.
5. Explain how to verify political contributions.
6. Explain how to verifyContributions to Defense Funds.
7. Explain how to verifyDirector's Remuneration.
8. Explain how to verifyDirector's Sitting Fees.
9. Explain how to verifyExpenditure on Corporate Social Responsibility.
10. Explain how to verify payment of dividend.
11. Explain Disclosure of Accounting Policies.
12. Explain how to audit share capital.
13. Explain how to audit issue of shares for cash
14. Explain how to verify issue of bonus shares.

15. What is the procedure to audit forfeiture of share?
16. What to verify redemption of preference shares?
17. How audit of share transfer is conducted?
18. Explain how to verify buy-back of shares?
19. Explain how to conduct audit of debentures.
20. Explain the provisions related to maintenance of accounts of a company.

B. State whether the following statements are 'True' or 'False':

1. Auditor should verify the authorized capital of a company shown in the Balance Sheet with the Articles of Association.

2. Under Section 129 the Companies Act, the Board of Directors have to lay before every Annual General Meeting the Balance sheet, the Profit and Loss account and the Directors Report.

3. The Companies Act, 2013, does not prescribe any format for Balance Sheet.

4. The Profit and Loss Account must be prepared as per Part II of Schedule III of Companies Act, 2013.

5. Issued capital is always higher than authorized capital.

6. Under Section 210 of the Companies Act, the Managing Director has to lay before every Annual General Meeting the Balance Sheet, the Profit & Loss Account and the Directors Report.

7. When minimum subscription stated in the offer documents is not received, the entire application money should be shown under unsecured loans in the Balance Sheet till the time share application money is refunded.

8. A company is not allowed to issue shares at discount unless they are sweat equity shares.

9. Shareholders are not entitled to receive Interest from the company on calls paid in advance.

10. The maximum capital that the company can issue during its life time is known as Authorized Capital.

11. Under Section 129 of the Companies Act, the Auditors have to lay before every Annual General Meeting the Balance sheet, the Profit & Loss Account and the Cash Flow Statement.

12. A share issued at a price above its face value is known as issue at premium.

13. No dividend is payable otherwise than in cash.

14. The value of imports of capital goods by the company during the financial year calculated on C.I.F. basis is to be disclosed separately in the notes to accounts.

15. A single resolution can be passed for the approval of the annual accounts and the payment of final dividends.

16. Section 129 provides that every Balance Sheet of the company shall give a true and fair view of State of Affairs of the company as at the end of the financial year.

17. Goodwill is a fictitious asset.

18. In case of interim dividend, the dividend declared by the Board of Directors is subject to the approval of the shareholders.

19. A share issued at a price lower than the face value is known as issue at premium.

20. Equity shares are those shares which are not preference shares

21. In case of final dividend, the dividend declared by the Boards of Directors is final.

22. Under Section 210 of the Companies Act, the share holders have to lay before every Annual General meeting the Balance Sheet, the Profit and Loss Account and the Directors Report.

23. Section 211 requires Profit and Loss A/c of company should give a true and fair view of Profit & Loss of the company for the financial year.

24. Arrears of cumulative preference dividend are a contingent liability.

25. Payment of interest is a charge against the profits.

26. The capital that can be issued only when the company goes for winding is known as “Reserve Capital”.

27. In case of companies the members can decide that no payment of dividend be made even if the board has recommended payment of dividend.

28. A instrument acknowledging a debt carrying fixed value of interest is known as debenture.

29. The Board is authorized by Articles of Association to make a call.

30. Section 52 of the Companies Act, 1956 deals with the issue of securities at premium.

31. Minimum application money should be 5% of nominal value of shares issued.

32. Depreciation is to be provided on investments annually.

33. Section 53 deals with issue of securities at discount.

34. Section 61 deals with alteration of share capital.

35. Section 66 deals with reduction of share capital.

36. The company deposits the application money in any bank.

37. Calls in advance cannot be accepted by a company, unless authorized by Articles.

38. Call made should be uniform on all shares of the same class.

39. The provisions of SEBI are applicable only to first issue and not subsequent issue.

40. Surplus on the re-issue of forfeited shares standing to the credit of share forfeited account can be distributed as dividend.

41. Security premium is a revenue gain & should be transferred to Profit and Loss A/c.

42. Reduction of share capital requires special resolution to be passed by shareholders.

43. Security premium should be disclosed in Balance Sheet on liability side under the head ‘Reserves and Surplus’.

44. Sweat equity shares can be issued at discount.

45. Subdivision of shares into smaller amount is an example of alteration of share capital.

46. Any new company can issue shares at discount.

47. Under CARO, 2016 auditor has to report on the valuation or revaluation of all the assets.

48. Rate of discount cannot exceed 10% unless authorized by the Central Government.

49. Reduction of share capital requires special resolution to be passed by shareholders.

50. Interest on calls in arrears cannot exceed 5% according to Table A.

51. Interest on calls in advance cannot exceed 6% according to Table A.

52. Debt equity ratio should be more than 2:1 after buy-back.

53. A company can issue only irredeemable preference shares as per Companies Act, 2013.

54. Debenture-holders are entitled to subscribe for the “rights issue”.

55. Buy-back should not exceed 40% of total of paid up capital and free reserves.

56. Dividend is an appropriation and not a charge against the profits.

57. CARO, 2016 Auditor has to report if a substantial part of fixed assets have been disposed off during the year, whether it has been done for a reasonable price.

58. Cash system of accounting means recording income & expenses when they are received or paid.

59. Capital Reserve is a revenue profit.

60. Transfer of shares due to death or bankruptcy of a shareholder is known as transmission of shares.

61. Issue of right shares should be authorized by Articles.

62. CARO, 2016 does not apply to a foreign company.

63. Security premium can be utilized for buy-back of shares.

64. Debentures can be issued at a premium.

65. Unclaimed or unpaid dividend should be transferred to special account which should be operative for 7 years.

66. Investment in subsidiary companies is valued at cost or not realizable value whichever is lower.

67. Issues of shares by capitalization of profit are known as bonus issue.

68. Interest on debentures is a capital expenditure.

69. Unclaimed or unpaid dividend should be transferred to special account which should be operative for 7 years.

70. The Companies Act requires accounts to be maintained on cash system.

71. Discount on issue of debentures should be written over the tenure of debentures issued.

72. The qualifications by the auditor should appear in the Notes of Accounts.

73. Stores & spares are disclosed under the head 'fixed assets'.

74. Sweat equity share are issued by the company to employees, directors at a discount for consideration other than cash.

75. Capital Reserve is a revenue profit.

76. The observations or comments of the auditors which have any adverse effects on the functioning of the company shall be printed in the auditor's report in capital letters.

77. The dividend so declared should be paid within the period of 30 days from the date of such declaration.

78. Section 128 of the Companies Act, 2013, contemplates that the company should maintain A/c to disclose true & fair view.

Answer:
True – 2, 4, 8, 10, 2, 13, 14, 20, 23, 24, 25, 26, 27, 28, 29, 30, 31, 33, 34, 35, 37, 38, 40, 42, 43, 44, 45, 48, 49, 50, 51, 56, 58, 60, 61, 63, 64, 65, 67, 69, 71, 74, 77, 78.

False – 1, 3, 5, 6, 7, 9, 11, 15, 16, 17, 18, 19, 21, 22, 32, 36, 39, 41, 46, 47, 52, 53, 54, 55, 57, 59, 62, 66, 68, 70, 72, 73, 75, 76.

Select the correct alternative:

1. The maximum amount that the company can issue is known as:
   a) Issued capital b) Authorized capital
   b) Subscribed capital d) Issued capital

2. Shares can be issued
   a) For cash b) For consideration other than cash
   c) Both a & b d) None of the above

3. The form of balance sheet is prescribed by
   a) Schedule III, Part I b) Schedule III, Part II
   c) Schedule VI, Part II d) Schedule I, Part A

4. Select the stages in right order.
   a) Allotment, application, calls
   b) Application, allotment, calls
   c) Calls, application, allotment
   d) Calls, allotment, application.

5. The value of imports by the company during the financial year
   a) Are disclosed in notes to accounts on FOB basis
   b) Are disclosed in notes to accounts on CIF basis
   c) Are not disclosed in notes to accounts if not used or consumed during the year
   d) Are disclosed in notes to accounts only in foreign currency.

6. The capital that can be called only when the company goes into liquidation.
   a) Reserve Capital b) Capital Reserve
   c) Subscribed Capital d) Issued Capital

7. A company is guided by
   a) The Companies Act, 1931 b) The Companies Act, 2013
   c) The Companies Act, 1934 d) The Companies Act, 1932.

8. A share that carries the right to a fixed amount of dividend at a fixed rate is known as
   a) Ordinary share b) Preference share
   c) Equity share d)Equity share held by promoters

9. Share Capital of the company is classified under
   a) Authorized Capital b) Issued Capital
   c) Subscribed Capital d) All of the above

10. The earnings in foreign exchange from export of goods
   a) Are disclosed in notes to accounts even if not received
   b) Are disclosed in notes to account on FOB basis
   c) Are disclosed in notes to accounts on CIF basis
   d) Need not be disclosed at all.

11. The fundamental objective of an external audit of a limited company is to
   a) Prevent and detect frauds
   b) Provide an opinion on the financial statements

c) Prevent and detect errors
d) To help the directors

12. Schedule III provides that
a) The Balance Sheet of the company is primary document
b) Profit & Loss A/c shown first & then the Balance Sheet
c) Nothing as such has been provided
d) Balance Sheet should be shown first & then Profit and Loss account

13. Section. 43 provides for following two classes of shares
a) Equity & Ordinary b) Equity & Preference
c) Ordinary & Bonus d) Ordinary & Right

14. Shares which are not preference shares are known as
a) Bonus Shares b) Equity Shares
c) Preference Shares d) Sweat Shares

15. Shares given a preference on repayment of capital and payment of dividend
a) Equity Shares b) Ordinary Shares
c) Preference Shares d) Right Shares

16. Issue of shares to employees/directors at discount for consideration other than cash is known as
a) Bonus Shares b) Subscribed Shares
c) Right Shares d) Sweat Equity Shares

17. Which section deals with maintenance of Books of Accounts
a) 128 b) 125
c) 130 d) 131

18. Noncurrent assets include the following except
a) Tangible assets b) Fixed Assets
c) Trade Investment d) Long term loans & advances

19. The rate of dividend on equity shares is recommended by
a) Board of Directors b) Auditors
c) Shareholders d) Managing Director

20. The amount received over and above the nominal value of shares is called as______
a) premium b) discount
c) surplus d) sweat equity

21. Company’s Accounts according to section 128 should be maintained on
a) Single Entry System b) Receipt basis
c) Cash basis d) Accrual basis

22. The maximum amount of call of the shares must not exceed.

a) 10% b) 20%
c) 25% d) 30%

23. Current Assets include the following except

a) Sundry Debtors b) Capital work in progress
c) Cash & Bank Balance d) Short Term Investment

24. The maximum rate of discount at which shares can be issued, unless provided by Central Government

a) 10% b) 5%
c) 15% d) 2%

25. The following are the examples of tangible fixed assets except

a) Land & Building b) Goodwill
c) Motor Vehicle d) Plant & Machinery

26. The objective of revising Schedule VI is /are

a) Make it transparent & use friendly
b) Make it compatible with Income Tax Act
c) Make it error free & Fraud Proof.
d) None of the above.

27. Bonus shares can be issued out of

a) Capital Redemption Reserve
b) Securities Premium
c) General Reserve
d) All of the above

28. Debenture issued by company is

a) Debt Instrument b) Capital
c) Current Liabilities d) Contingent Liability

29. Unpaid interest on debentures should be shown as

a) Loan b) Current Liability
c) Contingent Liability d) Provision

30. Divisible Profit means

a) Net profit before interest & tax
b) Profit which can be distributed as dividend
c) Profit which is transferred to General Balance
d) Profit & Loss appropriation account

31. Buy-back of equity share is governed by

a) Section 117C b) Section 68, 69 & 70.
c) Section 80 d) Section 100

Answers

[1 – b, 2 – c, 3 – a, 4 – b, 5 – b, 6 – a, 7 – b, 8 – b, 9 – d, 10 – b, 11 – b, 12 – c, 13 – b, 14 – b, 15 – c, 16 – d, 17 – a, 18 – c, 19 – a, 20 – a, 21 – d, 22 – c, 23 – b, 24 – a, 25 – b, 26 – a, 27 – d, 28 – a, 29 – b, 30 – b, 31 – b.]

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4

AUDITOR'S REPORT

Unit Structure

4.1 INTRODUCTION AND MEANING

The **Auditor's Report** is a formal opinion, or disclaimer thereof, issued by either an internal auditor or an independent external auditor as a result of an internal or external audit orevaluation performed on a legal entity or subdivision thereof (called an "auditee"). The report is subsequently provided to a "user" (such as an individual, a group of persons, a company, a government, or even the general public, among others) as an assurance service in order for the user to make decisions based on the results of the audit.

An auditor's report is considered an essential tool when reporting financial information to users, particularly in business. Since many third-party users prefer, or even require financial information to be certified by an independent external auditor, many auditees rely on auditor reports to certify their information in order to attract investors, obtain loans, and improve public appearance. Some have even stated that financial information without an auditor's report is "essentially worthless" for investing purposes.

It is important to note that auditor's reports on financial statements are neither evaluations nor any other similar determination used to evaluate entities in order to make a decision. The report is only an opinion on whether the information presented is correct and free from material misstatements, whereas all other determinations are left for the user to decide.

There are four common types of auditor's reports, each one presenting a different situation encountered during the auditor's work. The four reports are as follows:

4.2 UNQUALIFIED OPINION

4.2.1 MEANING

An opinion is said to be unqualified when the Auditor concludes that the Financial Statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the Financial Statements. An Auditor gives a clean opinion of Unqualified Opinion when he or he does not have any significant reservation in respect of matters contained in the Financial Statements. The most frequent type of report is referred to as the **Unqualified Opinion**. This type of report is issued by an auditor when the financial statements presented are free of material misstatements and are represented fairly in accordance with the accounting principles, which in other words means that the company's financial condition, position, and operation s are fairly presented in the financial statements. It is the best type of report an auditee may receive from an external auditor.

4.2.2 An Unqualified Opinion indicates the following:

(1) The Financial Statements have been prepared using the accounting principles which have been consistently applied;

(2) The Financial Statements comply with relevant statutory requirements and regulations;

(3) There is adequate disclosure of all material matters relevant to the proper presentation of the financial information subject to statutory requirement, where applicable;

(4) Any changes in the accounting principles of in the method of their application and the effects thereof have been properly determined and disclosed in the Financial Statements.

The Report consists of a title and header, a main body, the auditor's signature and address, and the report's issuance date. Traditionally, the main body of the unqualified report consists of three main paragraphs, each with distinct standard wording and individual purpose, however certain auditors have since modified the arrangement of the main body (but not the wording) in order to differentiate themselves from other audit firms.

The first paragraph (commonly referred to as the **introductory paragraph**) states the audit work performed and identifies the responsibilities of the auditor and the auditee in relation to the financial statements. The second paragraph (commonly referred to as the **scope**

paragraph) details the scope of audit work, provides a general description of the nature of the work, examples of procedures performed, and any limitations the audit faced based on the nature of the work. This paragraph also states that the audit was performed in accordance with the country's prevailing generally accepted auditing standards and regulations. The third paragraph (commonly referred to as the **opinion paragraph**) simply states the auditor's opinion on the financial statements and whether they are in accordance with generally accepted accounting principles.

4.3 QUALIFIED OPINION REPORT

A **Qualified Opinion** report is issued when the auditor encountered one of two types of situations which do not comply with generally accepted accounting principles, however the rest of the financial statements are fairly presented. This type of opinion is very similar to an unqualified or "clean opinion", but the report states that the financial statements are fairly presented with a certain exception which is otherwise misstated.

The two types of situations which would cause an auditor to issue this opinion over the Unqualified opinion are:

1. **Single deviation from accounting principles** – this type of qualification occurs when one or more areas of the financial statement do not conform with accounting principles (e.g. are misstated), but do not affect the rest of the financial statements from being fairly presented when taken as a whole.

2. **Limitation of scope** – this type of qualification occurs when the auditor could not audit one or more areas of the financial statements, and although they could not be verified, the rest of the financial statements were audited and they conform accounting principles.

The wording of the qualified report is very similar to the Unqualified opinion, but an **explanatory paragraph** is added to explain the reasons for the qualification after the scope paragraph but before the opinion paragraph. The introductory paragraph is left exactly the same as in the unqualified opinion, while the scope and the opinion paragraphs receive a slight modification in line with the qualification in the explanatory paragraph.

"Except as discussed in the following paragraph, we conducted our audit."

For a qualification arising from a deviation from accounting principles, the following phrase is added to the opinion paragraph, using the depreciation example mentioned above:

"In our opinion, except for the effects of the Company's incorrect determination of depreciation expense, the financial statement referred to in the first paragraph presents fairly, in all material respects, the financial position of…"

For a qualification arising from a scope of limitation, the following phrase is added to the opinion paragraph, using the inventory example mentioned above:

"In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to perform proper tests and procedures on the company's inventory, the financial statement referred to in the first paragraph presents fairly, in all material respects, the financial position of…"

Due to the phrases added to the scope and opinion paragraphs, many refer to this report as the **Except-For Opinion.**

4.4 ADVERSE OPINION REPORT

An **Adverse Opinion** is issued when the auditor determines that the financial statements of an auditee are materially misstated and, when considered as a whole, do not confirm with accounting principles. It is considered the opposite of an unqualified or clean opinion, essentially stating that the information contained is materially incorrect, unreliable, and inaccurate in order to assess the auditee's financial position and results of operation. Investors, lending institutions, and governments very rarely accept an auditee's financial statements if the auditor issued an adverse opinion, and usually request the auditee to correct the financial statements and obtain another audit report.

Generally, an adverse opinion is given only if the financial statements pervasively differ from accounting principles.An example of such a situation would be failure of a company to consolidate a material subsidiary.

The wording of the adverse report is similar to the qualified report. The scope paragraph is modified accordingly and an explanatory paragraph is added to explain the reason for the adverse opinion after the scope paragraph but before the opinion paragraph. However, the most significant change in the adverse report from the qualified report is in the opinion paragraph, where the auditor clearly states that the financial statements are not in accordance with accounting principles, which means that they, as a whole, are unreliable, inaccurate, and do not present a fair view of the auditee's as a whole, are unreliable, inaccurate, and do not present a fair view of the auditee's position and operations.

"In our opinion, because of the situation mentioned above (in the explanatory paragraph), the financial statements referred to in the first paragraph do not present fairly, in all material respects, the financial position of…"

4.5 DISCLAIMER OF OPINION REPORT

A Disclaimer of Opinion is issued in either of the following cases:

- When the auditor is not independent or when there is conflict of interest.
- When the limitation on scope is imposed by client, as a result the auditor is unable to obtain sufficient appropriate audit evidence.
- When there are significant uncertainties in the business of client.

A Disclaimer of Opinion, commonly referred to simply as a Disclaimer, is issued when the auditor could not form and consequently refuses to present an opinion on the financial statements. This type of report is issued when the auditor tried to audit an entity but could not complete the work due to various reasons and does not issue an opinion.

In the introductory paragraph, the first phrase changes from "We have audited" to "We were engaged to audit" in order to let the user know that the auditee commissioned an audit, but does not mention that the auditor necessarily completed the audit.

"We were engaged to audit the accompanying financial statements of XYZ Company Ltd. (the "Company") as of December 31, 2017. These financial statements are the responsibility of the Company's management.

The Company does not maintain adequate accounting records to provide sufficient information for the preparation of the basic financial statements. The Company's accounting records do not constitute a double-entry system which can produce financial statements……"

4.6 AUDITOR'S REPORT UNDER COMPANIES ACT 2013

Auditor has to compulsorily inquire and comment in his Report.

Section 143 requires auditor to inquire and report on the following matters:

4.6.1 Contents of auditor's report are discussed below:

(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 not prejudicial to the interest 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 the 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 papers of the company that any securities 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.

4.6.2. Auditor shall report whether the accounts give a true and fair view

The auditor has an obligation towards the members of the company to make a report to them on the account examined by him, and on every balance sheet and profit and loss account, which are placed before the company in annual general meeting during his tenure of office. The auditor has to state whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by this Act in the manner so required and give a true and fair view:-

(i) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and

(ii) in the case of the profit and loss account, of the profit or loss for its financial year.

4.6.3. The auditor's report shall also state:-

(a) whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purposes of his audit;

(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 audited under section 143 by a person other than the company's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report;

(d) whether the company's balance sheet and profit & loss account dealt with by the report are in agreement with the books of account returns;

(e) whether, I his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in section 133;

(f) in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company;

(g) whether any director is disqualified from being appointed or re-appointed as director under section 164;

(h) whether the cess payable has been paid and if not, the details of amount of cess not so paid;

4.6.4 Requirement to give comments in the Auditor's Report as per the Section 164(2) of The Companies Act 2013.

As per the section 164(2) of the Companies Act, 2013:-
No person who is or has been a director of a company which- (a) has not filed financial statements or annual returns for any continuous period of three financial years; or (b) has failed to repay the deposits accepted by it or pay interest there on or to redeem any debentures on the due date or pay interest due thereon or pay any dividend declared and such failure to pay or redeem continues for one year or more, Shall be eligible to be re-appointed as a director of that company or appointed in other company for a period of five years from the date on which the said company fails to do so.

4.6.5 Auditors are required to make independent investigations at to disqualification of director u/s 164(2):

Before reporting a particular person as being disqualified, an auditor must seek for the views and /or representations of the director concerned or any person as to whether he was a director of the defaulting company as mentioned in section 164. auditor's report really affects a particular persons right as his civil rights or status is necessarily declared in a negative way by the auditor by his fact finding. The rules of natural justice demand that before a person's right is affected, he/she should be given opportunity to explain his or her position.

4.6.6 Obligation on the Auditor's to comment on the compliance of the Accounting Standards, in the case of failure, the Auditor has to face the consequences

The Department has issued a Press Note which states that the provisions of section 143 of the Companies Act, 2013 have been amended, with an obligation on the part of the auditors of the companies to include a para in their report under section 143(3) of the Act to the member of the company, stating whether in their opinion the profit and loss account and the balance sheet comply with accounting standards. It further states that auditors of the companies are, therefore, advised to ensure that such a clause is added to their reports to the member failing which this Department will be constrained to take penal action against the auditors as well as refer the matter to the ICAI for initiating disciplinary proceedings against them.

4.6.7 Signature of the Auditor's Report, etc

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 sub-section (2) of section 141, and 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 and shall be open to inspection by any member of the company.

4.6.8 COMPANIES (AUDITOR'S REPORT) ORDER, 2016

COMPANIES AUDITOR REPORT ORDER (CARO) RULES, 2016 The MCA has issued the Companies (Auditor's Report) Order, 2016 (CARO 2016), on 29thMarch 2016. This order has been issued in supersession of the Companies (Auditor's Report) Order, 2015, and is applicable for reporting on financial statements of companies whose financial year commences on or after 1st April 2015. CARO 2015 was issued by MCA in supersession of CARO 2003 which was issued earlier in pursuance with the provision of Section 227 (4A) of Companies Act 1956. Now, the MCA has relaxed the applicability of CARO 2016 to private companies by increasing applicability thresholds. CARO 2016 will not apply to the auditor's report on consolidated financial statements. The total number of clauses in the new CARO is 16. CARO 2016 has enhanced the auditor's reporting requirements in certain areas, such as related party transaction and managerial remuneration.

4.6.9 Obligation to report the breach of law

Section 143 (11) of the Act stipulates that the Central Government may order for the inclusion of statement on specified matter in the auditor's report for specified class or description of companies. Accordingly, CARO 2016 is issued in pursuance of Section 143 (11) of Companies Act 2013 for inclusion of the matters specified therein in auditors' report.

Hence, CARO 2016 should be complied by the statutory auditor of every company on which it applies.

4.7 COMPANIES (AUDITOR’S REPORT) ORDER, 2016 (CARO)

4.7.1 Article Details:

Some additional responsibilities are being placed on the auditor under CARO-2016, are discussed below.

4.7.2 Applicability:

CARO 2016 applicable to every company including a foreign company as defined in clause (42) of Section 2 of the Companies Act 2013.

(a) Banking company as defined under Section 5 (c) of the Banking Regulation Act, 1949.

(b) Insurance company as defined under the Insurance Act 1938.

(c) Company licensed to operate under Section 8 of the Companies Act 2013 (companies registered with charitable object).

(d) A one person company (OPC) as defined under clause (62) of Section 2 of Companies Act 2013 (OPC means a company which has only one person as a member).

(e) A small company under Section 2 (85) of the Companies Act, 2013.

(1) As per sec 2(85) of Companies Act 2013 small company means a company, other than a public company:

a) Paid up share capital of which does not exceed Rs. 50 lacs or such higher amount as may be prescribed which shall not be more than Rs. 5 crore, and

b) Turnover of which as per its last profit and loss account does not exceed Rs. 2 crore or such higher amount as may be prescribed which shall not be more than Rs. 20 crore.

(2) The following company shall not qualify as a small company:

a) A holding company or a subsidiary company.

b) A company registered under Section 8 of the Act.

c) A company or body corporate governed by any special act.

(f) The auditor of following type of Private Companies are not required to comment on the matter prescribed under CARO 2016:

(1) A private company which is not holding or subsidiary company of a public company, and

(2) A private company having a paid up capital and reserve and surplus not more than Rs. 1 crore as on the balance sheet date, and

(3) A private company which does not have total borrowing exceeding Rs. 1 crore from any bank and financial institution at any point of time during the financial year, and

(4) A private company which does not have total revenue exceeding Rs. 10 crore during the financial year. Note: Such revenue means revenue as disclosed in scheduled III to the Companies Act, 2013 and includes revenue from discontinuing operation.

4.7.3 Fixed Asset [clause 3 (i)]

(a) Whether the company is maintain proper records showing full particulars including quantitative details and situation of fixed asset.
(b) Whether these fixed asset have been physically verified by management at reasonable interval.
(c) 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.

4.7.4 Inventory [Clause 3 (ii)]

(a) Whether physical verification of inventory has been conducted at reasonable interval by the management. (b) Whether any material discrepancies has been noticed on such verification and if so, whether the same has been properly dealt with in the books of account

4.7.5 Loan given by Company [Clause 3 (iii)]

Whether the company has granted any loans, secured or unsecured to companies, firms, LLP or other parties covered in the registered maintained under Section 189 of the Companies Act, 2013. If so,

(a) Whether terms and conditions of the grant of such loan are not prejudicial to the company's interest.

(b) Whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments and receipts are regular

(c) If the amount is overdue, state the total amount overdue, state the total amount overdue for more than 90 days and whether reasonable steps have been taken by the company for recovery of principal.

4.7.6 Loan to director and investment by the company [Clause 3 (iv)]

In respect of loan, investment, guarantees and security whether provision of Sections 185 and 186 of the Companies Act, 2013 has been complied with. If not, provide the details thereof.

4.7.7 Deposits [Clause 3 (v)]

In case, the company has accepted deposits, whether the following has been complied with: Directives issued by the reserve bank of India (a) The provision of sec 73 to 76 or any other relevant provision of Companies Act, 2013 and the rules framed there under, and (b) If the order has been passed by company law board (CLB) or National company law tribunal (NCLT) or RBI or any court or any other tribunal. (c) However, if any of the above not complied with, the nature of contraventions should be stated.

4.7.8 Cost Records [Clause 3 (vi)]

If Central Government has specified maintenance of cost records under sec 148 (1) of Companies Act, 2013 whether such accounts and records have been made and maintained.

4.7.9 Statutory Dues [Clause 3 (vii)]

(a) Whether the company is regular in depositing undisputed statutory dues with the appropriate authorities including Provident fund, Employees State Insurance fund, income tax, sales tax, service tax, duty of custom, duty of excise, value added tax, cess or any other statutory dues. If the company is not regular in depositing such statutory dues, the extent of arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they become payable, shall be indicated by the auditor.

(b) In case dues of income tax and sales tax or service tax or duty of custom or duty of excise or value added tax have not been deposited on account of any dispute, then the amount involved and the forum where dispute is pending shall be disclosed.

4.7.10 Repayment of Loan [Clause 3 (viii)]

Whether the company has defaulted in repayment of loans and borrowing to a financial institution, banks, government or dues to debenture holders. If yes, the period and the amount of default to be reported.

4.7.11 Utilisation of IPO and further public offer [Clause 3 (ix)]Whether money raised by way of initial public offer or further public offer and the term loans were applied for the purpose for which those are raised. If not, the details together with delays and defaults and subsequent rectification, if any, as may be applicable, be reported.

4.7.12Reporting of Fraud [Clause 3 (x)]

Whether any fraud by the company or any fraud on the company by its officers and employees has been noticed or reported during the year: if yes, the nature and the amount involved is to be indicated.

4.7.13 Approval of managerial remuneration [Clause 3 (xi)]

Whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provision of Section 197 read with schedule 5 to the Companies Act, 2013. If not, state the amount involved and step taken by the company for securing refund of the same.

4.7.14 Nidhi Company [Clause 3 (xii)]

Whether the Nidhi company has complied with the net owned funds to deposit in the ratio of 1:20 to meet out the liability and whether the Nidhi company is maintain 10% unencumbered term deposit as specified in the Nidhi rules 2014 to meet out the liability.

4.7.15 Related Party Transaction [Clause 3 (xiii)]

Whether all transaction with the related party is in compliance with Section 177 and 188 of the Companies Act, 2013 where applicable and the details have been disclosed in the financial statement etc., as required by the applicable accounting standard.

4.7.16 Private Placement of Preferential Issues [Clause 3 (xiv)]

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 Companies Act, 2013 have been complied with and the amount raised has been used for the purpose for which the funds were raised. If not, provide the detail in respect of the amount involved and the nature of noncompliance.

4.7.17 Non Cash Transaction [Clause 3 (xv)]

Whether the company has entered into any non-cash transaction with the director or person concerned with his and if so, whether the provision of Section 192 of Companies Act, 2013 has been complied with.

4.7.18 Register under RBI Act 1934 [Clause 3 (xvi)]

Whether the company is required to be registered under Section 45 IA of Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

4.7.19 Form of Audit Report:

CARO requires that the auditor should make a statement of the matters contained in the order. This requirement applies even where the answers to any of the questions are unfavourable or qualified. In such cases, the auditor should state his unfavourable answers and the reasons for the same. If the auditor is not able to express his opinion about any of the items contained in the order he should indicate such fact, and give reasons as to why he is unable to express an opinion.

4.8 AUDIT REPORT VS. POLITICAL CONTRIBUTION

Where a company contributes any amount directly or indirectly to any political party and the auditor is satisfied that political contribution has been made in excess of the limit prescribed in section 182, he should qualify his audit report, mentioning the excess amount involved, if ascertainable. Also where such contributions made by the company are within the limit but the facts regarding such contributions are not properly disclosed, the auditor should qualify his report and state the relevant facts. Where he is in doubt about the applicability of section 182, he should disclose this fact in his report. An auditor's duty as such is to examine and report on the accounts of the company in accordance with the requirements of section 143.The auditor therefore has no specific duty to make any special enquiry to unearth cases of unauthorized political contributions if they are not readily apparent from the examination of the accounts made in the normal course of the audit. If any unauthorized political contribution (of such contribution in excess of the permissible limit, as the case may be) has been skillfully concealed by a company or it has not come to the notice of the auditor in the normal course of his audit, an auditor would be responsible only to the extent it can be established that in the conduct of the audit he acted without reasonable care and skill.

Views of the Department

(1) The Department has impressed upon the Chartered Accounts, acting as statutory auditors of companies, through the ICAI, that it was their duty to comment on all such material violations of the law or sound account practice as might reasonably be expected to affect directly or indirectly the fortunes of the company's accounts.

(2) The requirements of the Act are that the auditors should specifically certify whether the published accounts give a true view of the company's state of affairs and of the profit and loss for the financial year (as compared with the requirements of certification as true and correct under the 1913 Act).

4.9 QUESTIONS

A. Short Notes

1. Qualified Opinion
2. Unqualified Opinion
3. Disclaimer of Opinion
4. Clean Report
5. Explain the applicability of CARO, 2016.

B. Theory Questions

1. Describe in brief contents of Audit Report.
2. Explain the provisions of CARO, 2016.
3. Distinguish between qualified and unqualified report.
4 Explain various types of Audit Reports.
5. Distinguish between disclaimer report and unqualified report.

C. Select the correct alternative

1.Scope of audit is communicated to the client in
a)Audit Report c) Representation Letter
b)Engagement Letter d) Annual Report

2.Where the auditor is unable to give his opinion due to insufficiency of evidence, then he gives_______________.
a)Adverse Opinion c) Disclaimer of opinion
b)Qualified Opinion d) Unqualified Opinion

3.The date of Audit Report should not be_______________.
a)Date of AGM b) Date of approval of accounts
c)Both (a) & (b) d) None of the above

4.The client changed the method of depreciation. It is disclosed as a note. It has immaterial effect on current financial statement. Which opinion should the auditorexpress?
a)Unqualified opinion c) Disclaimer of opinion
d)Qualified opinion d) Adverse opinion

5.Under CARO 2016, the auditor is not required to report on___________.
a)Arrears of preference dividend
b)Preferential allotment of shares to related party
c)Disposal of fixed assets
d)Unsecured loans granted to related party.

6.CARO is issued by______________________.
a)Board of Directors of the company c) Central Government
b)Comptroller and Auditor General d) None of above

7.A good report must be________________.
a)Factual c) Unbiased
b)Convincing d) All of the above

8.__________________ is also known as the clean report.
a)Qualified c) Modified
b)Unqualified d) Adverse

9.Audit Report is qualified when_________________.
a) Wrong method of depreciation is followed
b) Company law is violated
c) The auditor is unable to obtain information
d) All of the above.

10.A company auditor addresses his report to_____________.

a) Board of Directors	c) Members
b) M.D.	d) Company Secretary

11.The CARO shall apply to a company, which is engaged or proposes to be engaged in the following activities.
a) Manufacturing, mining or processing
b) Supplying and rendering services
c) Trading
d) All of the above

[**Ans.** (1 - b), (2 - c), (3 - b), (4 - a), (5 - a), (6 - c), (7 - d), (8 - b), (10 - c), (11 - d)]

D. Fill in the blanks with proper word

1. _____ is a statement of collected and considered facts about the accounts.
2. ____ ____ is an instrument through which the auditor expresses his opinion.
3. Audit Report should not be ____________________.
4. Audit Report is in the nature of _________________.
5. The scope of Audit Report is _________________than the scope of Audit Certificate.
6. __________________ provides for Audit Report.
7. Audit Report is addressed to the __________________.
8. The Report must be ________________ by the Auditor.
9. The report which says that financial statements company with GAAP is an ________________ Report.
10. Audit report reflects the work done by the_____________.

[**Ans.** (1) Audit Report; (2) Audit Report; (3) biased; (4) Verification;(5) wide; (6) A 528; (7) members; (8) signed; (9) unqualified; (10) Auditor]

E. Match the following

Group 'A'	Group 'B'
1. Audit Report	a) Whether financial statements comply with legal requirements
2. Section 143	b) Modified Report
3. Opinion Paragraph	c) Report to the members
4. SA 700	d) Qualified opinion
5. Qualified Report	e) Addressed to the members

F. State with reasons whether following statements are true or false.

1. Auditors is an expert in Accounts.
2. Audit Report must be factual.
3. Audit Report should be biased.
4. There is no difference in Audit Report and Audit Certificate
5. Companies Act, 2013 provides for Audit of the companies.
6. Audit Report is qualified when important books are maintained.
7. Audit Report need not be qualified even if wrong method of depreciation is followed.
8. A company limited by shares has to hold a Statutory Meeting.
9. The Auditor has to express his opinion about the books of accounts.
10. An Audit Report is a certificate of accuracy of accounting records and financial statements.
11. An Auditor's opinion in auditing situation involves exercise of judgment.

[**Ans.True:** 1, 2, 5, 8, 9, 11; **False:** 3, 4, 6, 7, 10]

❖❖❖❖

5

NEW STANDARDS ON AUDITING AUDITING STANDARDS 200 AND 210 AND 220

Unit structure:

5.0 OBJECTIVES

After studying the students will be able to understand:

- The need for Audit standards.
- The procedure for setting standards.
- Understanding of SA 200, SA 200A, SA 210 and SA 220.

5.1 INTRODUCTION

As long as the business unit was small and was managed by one owner: there was neither any need for maintaining accounts or Audit. However with the increase in the size of the business and emergence of partnerships and Joint stock company organizations there, was separation between ownership and management of business unit, there arose need for maintaining detailed account of the business transactions. Books of accounts were maintained by the employees and the owners like partners in a partnership firm and shareholders in a Joint Stock Company, are to be assured that these accounts are properly maintained. So, Audit of these accounts by an independent expert in the field was found necessary. Thus the profession of Auditors was slowly evolved.

An audit is defined as an examination of accounting records to establish their reliability and the reliability of statements drawn there from, It involves verification of accounting data, to determine their accuracy and reliability. It involves examination of books of accounts and vouchers. The Institute of Characters Accountants of India defines Auditing as "Independent examination of financial information of any entity, whether profit oriented or not and irrespective of size or legal form, when such an examination is conducted with a view to expressing an opinion there on".

Auditors' reports are read by owners like shareholders, Creditors, Bankers who want to lend money or investors in the shares of the company etc. If the accounts are audited, It is not a guarantee as to the future viability of an enterprise. Similarly auditor's report does not guarantee that the business is being conducted or managed efficiently. Still There is a general feeling in the minds of the public that Nothing can go wrong with an organization who's Accounts have been audited. So, it is extremely important that the auditors carryout their assignments with ut most Professional care and sincerity to uphold this faith reposed by the public in them.

In view of the importance of the audit, it was felt necessary that there should be some set standards for the conduct of the audit so that there is some uniformity in the conduct of audit. Every auditor will conduct the audit In the same manner and the reader of the audit report can presume that accounts have been properly audited even through they are audited by anybody.

5.2. NEEDS FOR AUDIT STANDARDS

International response to Auditing needs

To uphold the faith of the public in the profession of auditors. International Federation of Accounts (IFAC) was established in 1973. Its object was "worldwide development and enhancement of the accountancy profession… of high quality in the public interest". The International Auditing and Standard Board (IAASB) was established to improve the quality and uniformity of practice throughout the world. This Board issued International Standards on Auditing (ISA). IT also issued guidelines on the application of the ISAS.

At national level we have the Institute of Chartered Accountants of India Establish in 1949 to regulate the profession of Chartered Accountancy in India. This institute has taken numerous steps to ensure that its members discharge their duties with due professional care, competence and sincerity. It established Auditing practices committee or Auditing and Assurance Standards Board in September 1982. This issues standards on Auditing to be followed by all the Auditors in India. These standards are mandatory i.e. compulsory and every auditor has to follow them while auditing the accounts of any business entity. The Institute has so far issued 35. Audit standards and your syllabus contains the study of 12 out of them.

In this chapter, we will be studying the first three standards namely SA 200 dealing with basic principles that govern Audit and SA 200 A dealing with objectives and scope of the Audit of Financial statements SA 210 on agreeing the terms of audit engagements and SA 220 on quality control for an audit of financial statements.

In short Auditing standards represent a codification of the best practices of the profession, which already exist. These standards help the auditors in proper discharge of their professional duties. They also promote uniformity in practice as also facilitate comparability.

5.3 PROCEDURE FOR SETTING STANDARDS

Auditing and Assurance Standards Board of the Institute of chartered Accountants of India formulates these standards.

This Board first identifies the areas where such standards are necessary and prepares a list according to the priority. There are study groups of the Institute to help this board in its work. A draft auditing standard is first prepared and comments on the same are called for from the members. Taking into account these comments and suggestions of the members, standards are prepared and submitted to the council of the Institute. Council then takes a final decision on the same and then issues the standards. While finalizing the standards the board also takes, in to account the applicable laws, customs, Usages and business environment in the country.

Institute of Chartered Accountants of India is a member of the International Federation of Accountants. So, ICAI takes care to see that standards issued by it are in harmony with the International Standards on Auditing. International Federation has so far issued 39 standards and our Institute has issued 35 standards on the same lines and 3 more are in the pipeline.

As stated earlier, every auditor has to compulsorily follow these standards and where he cannot, he must give satisfactory explanation for the same. Otherwise he will be held guilty of professional misconduct and punished accordingly.

CHECK YOUR PROGRESS

a) What is meant by Audit?
b) Explain the need for standards in Audit?
c) Who frames Audit standards at national and international level?
d) How many standards are prepared so far by International Federation of Accountants and Institute of Chartered Accountants?
e) Are these standards optional or mandatory?

5.4 SA 200: BASIC PRINCIPLES THAT GOVERN AN AUDIT:

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010. It deals with professional responsibilities of an auditor. It should be followed while conducting audit of financial statement in accordance with SAs.

An audit is the independent examination of financial information of any entity. The Unit may be run to earn profit or not. It may be small or large. It may take any legal form like sole trader, partnership firm with limited or unlimited liability or a Joint stock company. It may also be a government or a semi-government organization or corporation. The Auditor is expected to express his frank opinion on the financial statements. The Auditor should adopt a proper auditing procedure. He should present his report in the required format if any format is prescribed by any law, applicable to that particular business. In preparing his report, the auditor should take in to account the special needs of the concern. The Auditors report should be drafted in clear and unambiguous terms and in simple language.

The Auditor should maintain integrity and should be straight forward and honest. He must be fair and unbiased. He should be impartial. He should not have any vested interests.

Integrity requires that the auditor should be honest and frank. He should express his thoughts without any fear or favour. Of course he must not disclose confidential matters.
During the course of his duties, he comes across number of confidential matters of the business like margin of profit, formula for preparation of a product etc. He must not disclose this information to anybody including the competitors or his clients.

There is no doubt that the auditor should be a person of integrity. But it will be difficult rather impossible to regulate the characteristic of integrity of auditor by issuing audit standards Therefore integrity is subjective and cannot be standardized by making law or by setting standards. As a matter of principle the auditor should be a person of integrity. He should not only be impartial but appear to be so. He should be free of any personal interest so that the society does not doubt his integrity.

Skills and Competence :

- Auditor should have adequate training and experience. He should have good general education, technical knowledge and practical experience.

He is concerned with business which is dynamic. There are lot of changes in the business and various laws and rules and regulations about the same.

- He should keep himself aware of latest developments, rules and regulations and statutory requirements. In short he must be up to date in his knowledge concerning his job.

- Audit of a joint stock company can be conducted only by a practicing Chartered Account or A Firm of Chartered Accounts.

- An audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit.

- SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

- In case of sole trader or partnership, though there is no prescribed legal qualification he should be adequately qualified for his job. Auditor should prepare his report with professional care. Auditor should insist that the management adopts appropriate accounting system and adopt proper policies in preparing financial statements.

Requirements :

- The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.
- The auditor shall remain alert and make necessary inquiries for evidence of non-compliance with relevant ethical requirements by members of the engagement team.
- The auditor shall form a conclusion on compliance with independent requirements that apply to audit engagement.

- Auditor should properly plan his work before starting his audit. For preparing a plan, he must study the special features of the business of the client. He must get himself satisfied that. The client is following a proper accounting procedure. If he finds any defects in the system, he must suggest changes in the system

Work performed by others :

When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for expressing his opinion on the financial information. So, before delegating work to subordinates and others, he should give them proper detailed instructions about the performance of the job and properly supervise the work done by them, because ultimate responsibility rests on him. However, he will be entitled to rely on the work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. The Companies Act 2013 permits audit of branches by other auditors. So, if any branch audit is conducted by any other auditor, he must clearly mention this fact in his report.

In short the Auditor cannot escape from the liability on the pretext that he/ she delegated the work to his/her assistants who did not do the work properly. The auditor continues to be liable or responsible for the work performed by his assistants. He should exercise due care in supervising the work of his assistants.

Documentation :

After the audit of a concern is complete, if anybody else wants to check whether the work is done properly or not, he will refer to the documents collected and used by the auditor while auditing the accounts of the concern. So, the auditor should maintain systematically the audit working papers, vouchers etc.

To prepare a proper plan of his work :

a) He must study the internal check or control system and decide how much he should rely on it.

b) The plan should be such as to co-ordinate. The work of different subordinates. He should distribute the work amongst his assistants in such a way that each one is capable of handling the work allotted to him. As far as possible, work should be distributed according to the liking of the subordinates. Auditor should take into account the qualifications experience and capacity of each subordinates while allotting him the work.

c) Plan once prepared should be meticulously followed. However, when there are any major changes in the circumstances which warrant changes in the plan, Such changes should be done in time.

Taking in to account the internal check system prevailing in the business, the auditor should decide whether to check 100% items or he can adopt test checking.

Audit evidence

The Auditor should insist on proper evidence. He should design a proper procedure to obtain evidence. Evidence produced should be complete, accurate and reliable.

Audit completion and reporting :

The end result of the auditing is the audit report and conclusion. Auditor's report should be based on evidence obtained.

Auditor should finally report that :

a) Financial statements have been prepared after following proper accounting policies. Policies should be consistently followed. They should not be changed, unless there is a strong reason for it. Whenever there is any such change in the policies, auditor's report should specifically mention the same in his report.

b) Auditor should report whether all statutory requirements have been complied with or not.

c) He should also report that there is adequate disclosure of all material facts.

Auditor's report should be in a proper form. If any form is prescribed by any law applicable to that business, it should be in that form. e.g. Reports at Bank audit, Tax Audit etc. are to be prepared in a particular form prescribed by the concerned Acts.

In the report, the Auditor should express his frank and honest opinion. When he has to give a qualified report, he should give his reasons for the same.

CHECK YOUR PROGRESS

1) What are the contents of S.A. 200?
2) When was it introduced?
3) How the auditor should prepare a plan of his work?
4) What is the responsibility of the auditor for the work performed by others?

5.5 S. A. 200 A: OBJECTIVES AND SCOPE OF THE AUDIT OF FINANCIAL STATEMENTS:

Financial statements include balance sheet. Profit and loss Account, cash flow statement and explanatory notes on the same. In short general purpose financial statements prepared by every business unit at the end of the year.

SA 200 A became operative from 1st April 1985 :

Financial statements are issued for the use of shareholders, members, creditors, employees and the public at large.

Objectives of an Audit :

Following are the objectives of an Audit .

1) To make sure that financial statements are prepared after following all accounting policies and practices and legal requirements.

2) To get convinced that the financial statements represent true and fair view of the financial position and operating results, of the enterprise. It should be remembered that the Auditors opinion is only on the financial statements. Reader should not assume that it is an opinion on the successful management of the enterprise.

Financial statements are prepared by the management. They should maintain proper books of the accounts. There should be effective internal control system. Accounting standards prescribed by the Institute of Chartered Accountants should be meticulously followed. Assets should be properly safeguarded. Audit of the financial statements does not relieve the management of its responsibilities in this regard. That is why, it is said that Auditing begins where accounting ends. i.e. with the preparation of the final accounts.

Auditors' opinion helps determination of the true and fair view of the financial position and operating results of an enterprise.

Scope of Audit :

Scope of Audit is decided by the terms of engagement of the auditor and relevant legal requirements, if any. Auditors appointed for different types of organizations have to perform different types of duties as per the laws applicable to respective organizations. e.g. Auditor of a bank is expected to perform his duties as prescribed by the Banking companies Act or Auditor of a co-operative society has to perform his duties as per co-operative Act etc. where there is no such special law, scope of his work is decided by the letter of appointment or an agreement entered into between the client and the auditor. In case where there is a special law governing the affairs of the concern, the appointing authority can increase the scope of audit of the Auditor but it cannot be restricted.

Information contained in the records should be sufficient for the auditor to form is opinion on the financial statements. Auditor should be satisfied that the information contained in them is reliable.

Before starting his work, Auditor should go through the prevailing internal control system in the organization. If he comes across any lacuna or defects in it, he must suggest suitable changes in it.

Financial statements should disclose information properly. Auditor should insist that accounting policies should be consistently followed. Information should be properly classified and suitably presented.

Audit cannot be relied upon to ensure discovery of all frauds and errors. As it is said the Auditor is a watch dog and not a blood hound. If there is any indication of error or fraud. Auditor should suitably change his method and reveal the same in his report. The Auditor is primarily concerned with material (important) items. Material items are those, which influence the decision. The Auditor can decide what is material and what is not, on the basis of his professional experience and judgment.

It should be remembered that the Auditor is not a technical expert. He is only a financial expert. So he should express his opinion only on the financial aspects.

Auditor should carry out enquiries and verify accounting transactions. He should ensure that necessary information is properly disclosed in the financial statements. He must compare the financial statements. He must compare the data in the books of accounts with the available evidence.

If the management has done any estimates in the financial statements, auditor should get himself convinced that these estimates are done on proper lines. The conclusions are drawn by the auditor, on the basis of the evidence made available to him. So, he is only expected to draw reasonable conclusions from it Absolute certainly in auditing is rarely attainable. So, the auditors report always starts with the words like "on the basis of the evidence produced before me…… etc".

The Auditor should be convinced that the financial statements reflect a true and fair view of the financial position and the operating results of the business unit.

Test checks are usually adopted in the conduct of the audit. So, the Auditor can never guarantee 100% correctness of the accounts or absence of any frauds. If he suspects anything fishy during the course of his verification, he should go deep into the matter. If the auditor is not fully satisfied, he should be bold enough to qualify his report and explain his position clearly.

Audit procedure should be so organized as to cover all aspects of the enterprise and all statutory requirements are complied with. Auditor should satisfy himself that the financial statements reflect the true and fair view of the financial position and operating results of the enterprise.

CHECK YOUR PROGRESS

1. What is an objective and scope of audit?
2. Who is responsible for the preparation of the financial statements?
3. From what date SA 200 A is made applicable?

5.5 S.A. 210: AGREEING THE TERMS OF AUDIT ENGAGEMENTS

Introduction:

This standard deals with the auditor's responsibility in agreeing the terms of audit engagement with management and those charged with governance (also known as TCWG).

Objective

The basic objective of the auditor is to accept or continue an audit engagement only when the basis upon which is to be performed has been agreed through, (a) Establishing whether the preconditions for the audit are present. (b) Confirming that there is common understanding with auditor and management or those charged with governance of the terms of audit engagement.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010

Scope of Audit

Scope of Audit is decided by the terms of engagement of the auditor and relevant legal requirements, if any. Auditors appointed for different types of organizations have to perform different types of duties as per the laws applicable to respective organizations. e.g. Auditor of a bank is expected to perform his duties as prescribed by the Banking companies Act or Auditor of a co-operative society has to perform his duties as per co-operative Act etc. where there is no such special law, scope of his work is decided by the letter of appointment or an agreement entered into between the client and the auditor. In case where there is a special law governing the affairs of the concern, the appointing authority can increase the scope of audit of the Auditor but it cannot be restricted.

Information contained in the records should be sufficient for the auditor to form is opinion on the financial statements. Auditor should be satisfied that the information contained in them is reliable.

Before starting his work, Auditor should go through the prevailing internal control system in the organization. If he comes across any lacuna or defects in it, he must suggest suitable changes in it.

Financial statements should disclose information properly. Auditor should insist that accounting policies should be consistently followed. Information should be properly classified and suitably presented.

Audit cannot be relied upon to ensure discovery of all frauds and errors. As it is said the Auditor is a watch dog and not a blood hound. If there is any indication of error or fraud. Auditor should suitably change his method and reveal the same in his report. The Auditor is primarily concerned with material (important) items. Material items are those, which influence the decision. The Auditor can decide what is material and what is not, on the basis of his professional experience and judgment.

It should be remembered that the Auditor is not a technical expert. He is only a financial expert. So he should express his opinion only on the financial aspects.

Auditor should carry out enquiries and verify accounting transactions. He should ensure that necessary information is properly disclosed in the financial statements. He must compare the financial statements. He must compare the data in the books of accounts with the available evidence.

If the management has done any estimates in the financial statements, auditor should get himself convinced that these estimates are done on proper lines. The conclusions are drawn by the auditor, on the basis of the evidence made available to him. So, he is only expected to draw reasonable conclusions from it Absolute certainly in auditing is rarely attainable. So, the auditors report always starts with the words like “on the basis of the evidence produced before me…… etc”.

The Auditor should be convinced that the financial statements reflect a true and fair view of the financial position and the operating results of the business unit.

Test checks are usually adopted in the conduct of the audit. So, the Auditor can never guarantee 100% correctness of the accounts or absence of any frauds. If he suspects anything fishy during the course of his verification, he should go deep into the matter. If the auditor is not fully satisfied, he should be bold enough to qualify his report and explain his position clearly.

Audit procedure should be so organized as to cover all aspects of the enterprise and all statutory requirements are complied with. Auditor should satisfy himself that the financial statements reflect the true and fair view of the financial position and operating results of the enterprise.

Requirements for SA 210

Preconditions for an Audit

The auditor shall; determine financial reporting framework to be applied in preparation of financial statement; Obtain agreement of management that is takes responsibility for preparation of financial statements in accordance with acceptable financial reporting framework and for such internal control as it determines necessary to maintain financial statements free from material misstatement, whether due to fraud or error.

Management needs to provide the auditor access to all the information of which management is aware that is relevant to the preparation of thefinancial statements. Auditor may request any additional information for the purpose of audit. Auditor to be provided with unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Limitation on scope Prior to Audit Engagement Acceptance

The auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Other Factors Affecting Audit Engagement Acceptance

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: If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable.

Agreement on Audit Engagement Terms

- ➢ 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

Recurring audits

In case of recurring audits, auditor should assess whether the circumstances require the terms of audit engagement to be revised and whether there is a need to the entity of the existing terms of audit engagements.

However, auditor will send engagement letter in the following circumstances:

1. When there is change in ownership.
2. When there is change in senior management.
3. Change in reporting requirements.
4. Change in law or regulations.

Acceptance of change in terms of audit engagement

1. The auditor shall not agree to change in audit engagement, unless there is reasonable justification for doing so.
2. If prior to completing the audit, auditor is requested to change the audit engagement to the engagement that conveys lower level of assurance, the auditor shall determine whether there is a reasonable justification for doing so.
3. If the terms of audit engagement are changes, the auditor along with the management will record the existing terms of an audit engagement.
4. If auditor is unable to agree to a change in terms of audit engagement and is not permitted by law to continue with original engagement, the auditor may withdraw from such engagement where possible under applicable law or regulation.

Example of an Audit Engagement letter

To,
The Board of Directors
ABC Ltd.

With reference to your letter dated _____, we would like to inform you that we are pleased to conduct the audit of financial statements comprising of:

1. Balance sheet as at_______
2. Statement of profit and loss account for the period ended.
3. Cash flow statements and
4. Notes to accounts.

Our responsibility is to give an opinion on financial statements. We conduct audit as per the standards of auditing issued by the Institute of Chartered Accountants of India. Those standards require that we comply ethical requirements and plan and perform audit to obtain reasonable assurance that financial statements are free from material misstatements. Our audit involves in obtaining sufficient and appropriate evidence, evaluating the internal control systems and usage of sampling technique wherever required.

We would like to bring to your attention that management is responsible for:

1. To prepare the financial statements as per financial reporting framework.
2. To safeguard the assets of the entity.
3. Prepare financial statements on going concern basis.
4. To design, implement and maintain internal control systems.
5. To maintain the books the accounts.
6. To provide all information and explanation to the auditor.

Our audit process will be subject to peer review as per the requirements of ICAI. The reviewer may inspect, examine and get abstract of working papers.

Fees charged will be ___/-, and GST will be chargeable at the applicable rates.

If all the terms and conditions are acceptable, please sign and send a copy back to us expecting your full co-operation for completing your audit.

Signature:
Membership number:
Firm registration number:
Date:
Place:
Client's signature:

5.6 SA 220: QUALITY CONTROL FOR AUDIT WORK

This standard deals with maintaining Quality in the audit work. Quality is important in every walk of life and the Audit cannot be an exception to it. Audit plays a very important part in any business activity and importance of quality control in the same, need not be over emphasized.

Audit is a group task. It involves following four types of people.

a) The Auditor means a person with final responsibility for the entire audit work and audit report.

b) Audit Firm means either the partners of a firm providing audit services or a sole practitioner providing Audit services. In practice audit firms are more common than individuals providing such services. This may be due to some inherent advantages in the partnership firm specially in such types of professions.

c) Personnel means all partners and professional staff engaged in the audit work of the firm or in other words, the staff actually performing the job.

d) Assistants means personal involved audit, other than the Auditor i.e. Persons like Articled clerks or regular employees in the audit firm.

All these persons in the group have to follow the rules of quality control to produce quality job.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Special and conscious efforts are necessary to maintain quality in the Audit work. Special policies are to be evolved and meticulously followed by all the concerned. Such policies are to be implemented at both (a) the level of Audit firm and (b) on individual audits.

The Auditor has the final responsibility for the Audit. Audit firms may be owned by a partnership firm or a sole trader. These

Audit firms have a number of assistants who actually do the work of audit. All of them, may or may not be fully qualified Chartered Accountants but they should be educated enough and must be familiar with the audit work and the normal procedure to be followed .

Every Audit firm should implement quality control policies and procedure to ensure that all audits are conducted in accordance with Auditing standards. So, quality control policies should be communicated to all the four categories of the above personnel involved in audit. Role of each one of them is equally important. This will ensure that the audit works is conducted according to the prescribed standards.

Everybody concerned should understand thoroughly these policies and actually implement them while conducting the audit work.

The objectives of quality control policies

1) 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.

2) Every Audit Firm should adhere to the principles of Independence, Integrity, Objectivity, confidentiality and professional behavior as stated in SA 200. The Auditor should be an independent person. He should not have any vested interests in the firm whose books & accounts he is auditing. He must not disclose secret information about the firm to outsiders. As it is said, the Auditor should have his eyes and ears open but his mouth shut. His professional behavior should be of a highest degree.

   Assignment of Engagement teams :

- The firm should have necessary skills and competence. Personnel in the firm should be duly qualified as per legal requirements and are competent to undertake the work of audit.

- The audit work is distributed by the auditor amongst his different assistants. While dividing the work amongst different assistants, the auditor should ensure that every assistant is duly qualified and possess necessary skill and experience and is competent enough to discharge the duties allotted to him.

3) While delegating the work, the chief Auditor should give proper instructions and directions to all his assistants. Subsequently he should supervise and review their work from time to time. If the assistant commits any mistakes in his work, the boss i.e. The Auditor is held responsible for them. He cannot escape his responsibility saying that he had delegated that work to his assistant.

4) The Auditor should discuss about the work with all his Personnel from time to time. As and when there is any important matter, he may also discuss the matter with the outside experts in the field. There is nothing wrong in consulting or discussing the matter with the outside experts.

5) The Audit Firm should adopt proper personnel policies and maintain good public relations. The existing clients should be retained and all efforts should be made to secure new clients. He should secure new clients without adopting any unfair means and without compromising on his dignity.

6) The quality control policies should be properly monitored.

While distributing the work amongst different assistants, Auditor should see that the right job is allotted to a right person. Every person to whom a particular job is allotted, should be properly qualified and competent to perform that job. In other words, personal likes and dislikes, should be taken in to account while distributing the work amongst different assistants.

Before assigning the job, the Auditor should fully explain to him the job to be performed. He should be given detailed and proper instructions necessary to do the job. Procedure to be followed should be explained to him. He should also be given an idea about the possible difficulties he may encounter while performing those tasks. Overall Audit plan should be explained to him and importance of his job in the overall plan should also be explained to him.

The Auditor should then supervise the work being done by his assistants. He should give them guidance as and when found necessary. Finally the work performed by them should be reviewed by him from time to time.

Supervisor should monitor the progress of the work. Whenever there are any differences between the professional judgments of two persons, the supervisor should resolve the difference. There should be open discussion or a consultation amongst different assistants from time to time. Help of the outside expert should also be sought if found.

Audit Review :

The work performed by each assistant should be reviewed by competent persons. He should convince himself that the work has been completed according to the earlier decided audit program and the work done has been properly documented. Matters discussed and resolved during the audit work should be recorded. The objectives of the audit should have been fully achieved and the audit conclusions are adequately supported by available evidences.

Audit program is prepared before the commencement of the audit. However, this program should be reviewed from time to time as there are possible changes in the circumstances. In the case of large audits this review of the work may be done by an outside independent expert completely or partially .

Sometimes, one partner of the Audit Firm completes the audit work but the same has to be finally certified by another partner in the absence of the partner completing the work like his death or any other compelling reason. In such circumstances the partner actually certifying, should not blindly sign the documents presuming that everything must have been properly done by the previous partner. He should personally review the work done by the previous partner. He should personally review the work done, go through the relevant work papers and then sign the report and other documents only if he is personally satisfied.

The purpose of this standard is to establish standards on the quality control of policies and procedure of audit. Quality control is necessary at individual as well as firm level. Rules regarding professional requirements for the auditor should be strictly followed delegation of work to the assistants should be done on scientific basis. Work performed by the assistants should be reviewed by the supervisors.

The Audit program is an important tool for the communication of audit directions. Time budgets and overall audit plan is also useful in communicating audit directions.

CHECK YOUR PROGRESS

1) What are the different personnel involved in audit work?
2) What is the importance of quality control in audit work?
3) Date from which this SA 220 became effective?
4) What are the objectives of quality control policies?
5) Discuss the importance of proper distribution of job amongst different assistants?

6) What is the importance of supervision and review in the process of quality control policies?

5.7 SUMMARY

In this lesson you have studied the importance of standards on Auditing and details about the following in three standards.

1) SA 200 which deals with basic principles governing Audit and objective and scope of the Audit of financial statements.
2) SA 210 on agreeing the terms of Audit Engagements.
3) SA 220 Quality control for Audit work.

In view of the importance of the Audit, need for setting standards for its conduct was felt necessary at international and national level. At international level federation of Accountants frames such standards and at national level Institute of Chartered Accountants frames them. So far our Institute has issued 35 standard and they are all mandatory.

SA 200 deals with basic principles of audit like integrity, independence, skills and competence, confidentiality, etc of the Auditor. 200 A deals with objectives and scope of the audit of financial statements. Financial Statements include Balance Sheet, Profit and Loss Account, Cash Flow statements and other explanatory notes on the same. The Auditor should be convinced that the financial statements reflect a true & fair view of the financial position and the operating results of the business unit.

SA 210 (Revised) deals with Agreement of terms of auditing and engagements. The Auditor prepares this letter of engagement stating, the terms and conditions of his appointment and actual scope of his work. The method of calculation of his fees may also be stated. This letter is prepared in duplicate and one copy is returned back to the auditor by the client with his signature. This means that the client agrees with all the terms stated there in. Sometimes need may arise to amend the terms agreed upon or the client or the auditor may seek for such change. Auditor should agree for such changes only if he finds that they are reasonable. Auditor should always maintain the dignity of his profession.

The Auditor has a right to access to all books of accounts and other relevant documents. He has access to all officials of the concern and he can ask them explanation as and when he feels necessary. While reappointing the same auditor next year, terms of engagement may be changed if found necessary with mutual consent.

SA 220 deals with quality control for Audit Work Quality control procedures should be evolved for all the four concerned personnel namely the Auditor Audit Firm, professional staff and assistants. Every staff member engaged in the audit work should be duly qualified and possess necessary experience in the field Detailed instructions should be given to the assistants by the auditor, while dividing the work amongst different assistants. Right man should be given the night job. There should be strict supervision over the work of the assistants and their work should be reviewed by competent superiors from time to time. Help of outside experts may also be taken as and when found necessary. Old clients should be retained and new clients should be secured maintaining the dignity of the profession. Progress of the work should be monitored by the supervisor and time schedule framed for audit work should be adhered to as far as possible.

5.8 QUESTIONS

A. Descriptive Questions

1. What are the basic principles that govern an audit?
2. Explain the importance of maintaining confidentiality by the auditor?
3. "Auditor should keep his eyes and ears open but his mouth shut". Explain.
4. Who is responsible for the preparation of financial statements?
5. Explain the importance of Letter of Engagement.

B. Fill in the gaps.

a) SA 200 deals with -------------
b) SA 210 discusses --------------
c) Quality control for Audit work is discussed by SA -----------------
d) SA 200 was made effective from -------------
e) SA 210 is applicable to all audits conducted on or after -----------
f) SA 220 is made effective from -------------
g) Audit standards are passed in India by --------------
h) So far ------------- standards on Audit have been prepared.

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6

THE STANDARDS ON AUDITING 230,240, AND 300

Unit Structure :

6.0 OBJECTIVES

After studying the unit the students will be able to understand:

- Utility or usefulness of working papers as per AS 230
- Matters arising after the date of auditor's report as per AS 230
- Ownership of working papers as per AS 230
- Responsibility of Auditor for frauds and errors as per AS 240
- Definition and procedure for Audit Planning as per AS 300

6.1 INTRODUCTION:

In the earlier chapter you studied Audit Standards 200 (revised) dealing with Basic Principles that govern an Audit, S. A. 200A on objectives and scope of the Audit of Financial Statements, SA 210 on agreeing the terms of auditing engagements and SA 220 on quality control for Audit Work. In this chapter you will be studying the next three standards on Audit namely SA 230 on Audit Documentation, SA 240The Auditor's Responsibility is relating to Frauds in Financial Statements and SA300 about planning an audit of Financial Statements. Now let us study them one by one.

6.2 AUDIT STANDARD 230 AUDIT DUCUMENTATION:

This standard deals with documentations to be prepared for Audit of Financial Statements. Documentation refers to the working papers prepared and obtained by the Auditor. They are to be retained by him. During the course of audit, auditor collects number of papers, they are called documents or working papers and they are to be retained carefully in a file.

Objective :

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.

Utility or usefulness of working papers:

Documentation means the evidences on the basis of which the auditor draws his final conclusions. The auditor should maintain such evidence to show that the audit was performed in accordance with the set procedure prescribed by different SAs (Standards On Auditing). These documents assist the audit team to prepare their audit plan. As per SA 220 on quality control, supervision and review of audit work is necessary. Documentation facilitates the work of supervision and review of audit work. This paper also facilitates the work of audit of the auditor in subsequent years. They are also useful for controlling the quality of the audit work done.

Audit documentation means the record of the audit procedures performed, evidences obtained and the conclusions drawn by the auditor. On their basis audit file may be prepared storing all this necessary data. The file may be prepared in a physical form or electronically as per the normal practice followed by the auditor. However, the present trend is to prepare the file electronically as it is more safe and convenient store and to refer back as and when required.

For proper documentation, the auditor should have proper knowledge of the audit process, knowledge of relevant standards and the business environment of the particular business whose accounts he is auditing. These documents should be prepared in time, preferably during the course of audit or as soon as the audit is completed. Such file should be prepared at the most within 60 days of the completion of the audit. If there is delay in preparation, the data collected may not be 100 percent correct.

Auditor should keep a proper record of all verification done by him during the process of audit. He should keep a record of various discussions on important points; he had with different concerned officials of the client. He must also note down the evidences he inspected and the conclusions he had arrived at.

There should be a proper record of who performed the audit with date and time of performance. Similarly there should also be the name of the person who supervised and the name of the person who reviewed the work with date and time. Such record will be very useful to fix responsibility for any mistake committed when any enquiry is conducted subsequently.

During the course of audit the auditor has to discuss different matters with different authorities of the client. He should note down important points of such discussion and the names and designations of such officials with date and time. (*If he discusses certain matters with some outside experts, he should keep record of such discussion with the name of the expert, date and time*)

Sometimes, the auditor may have to follow a different procedure for the audit of a particular firm. This procedure may be different from the normal procedure followed in case of other audit. In such circumstances, the auditor should give details of the procedure he followed and justify giving reasons, his decision to follow such a different procedure in this particular case.

The auditor should collect all necessary papers required by him for his audit work promptly. This will help him in completing his work in time and also help him to improve the quality of his work.

The form, content and extent of documentation depend upon the size and complexity of the business of the client. It also depends upon the nature of audit procedure adopted and the significance of evidence collected etc.

Examples of documents to be collected are:

(a) Audit Programme
(b) Letter of confirmation of engagement
(c) Representation submitted to the management if any
(d) Other correspondence conducted during audit work etc.

The auditor may also record the different legal documents agreements etc. that he verified during the course of his audit.

However it should be remembered that above documents are not a substitute for regular books of accounts.

Audit documentation should be sufficient and appropriate in the prevailing circumstances. There cannot be any hard and fast rule about the same. Auditor should use his discretion on the basis of his past experience.

Some standards on audit (SAs) have specifically prescribed certain documentation. Such documents must be there in the file. In addition the auditor may include some additional documents which he feels necessary even though the SAs have not prescribed them.

These various documents in the file go to prove that the audit work has been completed according to different standards prescribed. However it is not necessary or practical to have documents for every matter considered or judgement made by the auditor. Only important points should be documented.

Audit plan in the file proves that the auditor has properly planned his work. A copy of letter of engagement proves that the terms of audit have been agreed upon by the auditor and the client.

Auditor should make documentation of all important professional judgements he has made during the course of the audit. Such records are useful to those who subsequently review the work of audit. Similarly these documents are also useful to the auditor who audits the accounts of the concern next year.

Management's might have made some estimates in the accounts. The decision of the auditor on the point of the reasonableness or otherwise of these estimates is an example of professional judgement. Auditor may also decide during the course of audit, whether the evidences or documents produced before him are authentic or not.

In case audit of large concerns it is not physically possible to verify or check each and every item. It may also be not necessary if there is a reliable internal check system. In such cases the auditor adopts the method of test checking. For Example, he may decide to check all items of purchases for a particular period or all purchases for an amount above a particular figure etc. Thus he may adopt some criteria in selecting the items for detailed checking. This fact should be recorded in his notes.

If the size of the business entity audited is small, the documentation required may also be on a small scale. However in case of large concern, documentation may have to be done on a large scale. SAs are designed to achieve overall objective of the audit. So, the documentation requirement applies only to requirements that are relevant in the circumstances. As seen earlier there cannot be any hard and fast rule about the extent of documentation in each case. The auditor has to use his discretion and decide.

If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document the circumstances encountered, any additional audit procedures performed, their effect on the report and how are the resulting changes made and reviewed.

Matters arising after the date of auditor's report:-

During the course of audit sometimes the auditor misses certain important items. They may come to his notice, after he finalised his report. In such cases, he must recheck the accounts and amend his report accordingly. He must record in writing reasons for adopting this course of rechecking of accounts. However such course is adopted only if the matters escaping his attention earlier are important.

SA 220 on quality control requires that the auditor should establish his policies and procedures at the very outset so that he can complete the audit in time. All audit papers should be carefully retained at least for a period of not less than seven years after the completion of audit report as per the provisions of Institute of Chartered Accountants Act, 1949.

Working papers are evidences of the actual work done by the auditor. They explain how the auditor arrived at his conclusions. Efficiency of the work increases with the proper maintenance of the audit papers. Work can be equitably distributed amongst different assistants and the quality of the work done can be controlled. If any mistakes are later noticed, responsibility for the mistake can be easily fixed with the help of these working papers. Because, you can easily find out from these papers, what part of the job is performed by every assistant. If any court cases arise subsequently, working papers can be produced as evidence of work done.

Number and nature of working papers is decided by the size and nature of business of the client. Audit papers may consist of things like Memorandum of Association and Articles of Association of the company, Partnership Deed in case of a partnership firm, Minute Books of different meeting held in the company, Letter of Engagement, Annual Financial Statements, etc. Some of these papers are of permanent nature whereas others may pertain to the affairs of the current year only.

I A permanent audit file normally includes the following:

(1) Information concerning the legal and organizational structure of the entity. In the case of a company this includes-

(2) Memorandum and Articles of Association, in the case of a statutory corporation, this includes the act and regulations under which the corporation functions and in the case of partnership firms the Deed of Partnership etc.

(3) Extracts of copies of all important legal documents, agreements and minutes relevant to the audit.

(4) Details about the internal control system in the organisation

(5) Copies of audited financial statements of previous years.

(6) Significant ratios and trends calculated.

(7) Letters issued by the management to the auditor

(8) Correspondence with retiring auditor if any.

(9) Details of accounting policies.

(10) Important audit observations of earlier years etc

(11) Name, nature and complexity of the business of the client.

II The current file may contain the following documents:

(1) A copy of the letter accepting annual reappointment.

(2) Minutes of Board Meetings and Shareholders' General Meetings in connection with accounts

(3) Current years' Audit Programme

(4) Analysis of transactions and balances

(5) Audit procedure followed.

(6) Distribution of work amongst different assistants.

(7) Correspondence of the auditor with third parties, other auditor and experts if any

(8) Details of matters discussed with the client and his different officials

(9) Letter of representation or confirmation from the client etc.

Ownership of working papers:

There is a controversy about the ownership of the working papers. Some people argue that it lies with the auditor as he has prepared them. Others argue that as they contain important and confidential information about the business of the client, ownership is with the client. However now it is settled that ownership belongs to the auditor only. But he is duty bound, not to disclose any information in the working papers to outsiders. As per SA 200 and code of conduct the auditor is expected to maintain secrecy about the business of the client. If it is found that he discloses any secret information to any outsider, the Institute of Chartered Accountants can take action against him for violation of code of conduct or for such unprofessional behaviour.

However, there is a decided case of Supreme Court on the lien of auditor. In the case of R. D. Saxena v/s Balram Prasad Sharma in 2000. The Supreme court has held that the auditor has no lien on these papers and he cannot retain them with him for non-payment of his fees. If his fees are not paid, he can adopt regular legal procedure to recover his dues.

The normal practice is that the auditor keeps these papers with him as they are useful to him to defend himself if any case is filed against him subsequently for negligence in duty etc. (*however he should adopt a reasonable procedure for the safe custody and confidentiality of these working papers*).

If the accounts of the branches are audited by different auditors, the principal auditor has no legal right to demand the working papers of the branch. However, he can ask for Xerox copies of certain documents as he prepares his final report on the basis of the reports of the branch auditors. At any rate cooperation and co-ordination between the principal and the branch auditor is necessary for the smooth working of the audit process.

Some of the working papers like schedules etc may be prepared by the client's personnel. However the auditor should accept such papers only after duly verifying their correctness.

In short the working papers should be sufficiently complete and detailed and they should be properly designed and carefully retained.

Auditor should finally prepare his report. At the conclusion of the work, he should prepare a short report or summary of the work he has done, what problems he faced and how he solved them etc.

In its original form the standard was made effective from 1st July, 1985. However SA 230 was implemented in its revised form from 1st April, 2009.

Audit Note Book,

In addition to the file of documents, usually the auditor maintains a special note book or diary in which he notes down all important figures and points he comes across during the course of audit and the summary of important points on which he had discussion with different officials of the client. Such note book will help the auditor in preparing his find report. It can also be presented as evidence in the court of law, if any case is filed against him for negligence etc. Auditor can also get information about the progress of the work from this note book.

CHECK YOUR PROGRESS

1) What is documentation?
2) What it is its importance?
3) Who has the ownership of working papers?
4) Examples of permanent documents and current papers.
5) Date from which the SA was made effective.

6.3 AUDIT STANDARD 240 (THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUDS IN THE AUDIT OF FINANCIAL STATEMENTS.)

The auditor is appointed to verify the correctness of the accounts. It is his duty to detect and prevent errors and frauds. He has to certify that the statements of accounts i.e. balance sheet, profit and loss account, cash flow statements and other accompanying documents, do not have any misstatements and they reflect true and fair view of the financial position of the concern.

However, we cannot say that the account statements prepared by the auditor after auditing the accounts are hundred percent correct and all the errors and frauds have been detected and set right. After all the auditor is also a human being and there are possibilities of errors and frauds in the account statements even after they are audited. They may be noticed subsequently. After all the auditor is not an insurer. This standard on audit deals with the responsibility of the auditor if errors or frauds are subsequently noticed in the statement of accounts.

Misstatements in the account statements are due to errors and frauds in the accounts. So, let us now consider the difference between errors and frauds.

Though both falsify the accounts, there is a basic difference between the two. Errors are committed by the employees inadvertently due to lack of knowledge of principles of accounts or through oversight etc. but the frauds are committed by the employees, management or other third parties connected with the concern intentionally to make some illegal gain.

Let us consider further details about them.

ERRORS

Errors are unintentional misstatements in the financial statements. They include omission of certain information or honest mistakes in calculation of some data or incorrect estimate of some figures through oversight. There may also be mistakes in application of accounting principles or wrong classification or presentation of data.

There are four types of errors.
(1) Errors of commission
(2) Errors of omission
(3) Errors of principles
(4) Compensating errors.

(1) Errors of Commission.

Here a transaction is recorded wrongly in the books of accounts. Examples of errors of commission are posting errors (like posting a wrong amount or posting to a wrong side of the account or posting to a wrong account etc), casting or totalling errors, carry forward errors and errors of duplication. Error of duplication means the same transaction is entered twice by mistake.

(2) Errors of omission.

Here a transaction is not recorded wholly or partially. Example of partial error is posting an entry on one side only. Here the trial balance will not agree. However if there is a total omission, the trial balance will agree in spite of this error. So, comparatively it is easier to detect a partial omission than to detect a complete omission

(3) Errors of Principle.

Here a transaction is recorded in an incorrect manner. Such errors may be committed due to lack of knowledge of accounting principles. They may or may not affect profits. However, such errors may also be intentionally committed to inflate or deflate the profits. E.g. repairs to machinery may be debited to machinery account to inflate profits or purchase of some small machinery may be debited to machinery repairs account to deflate the profits. etc.

(4) Compensating errors.

Here one error is compensated by another error. Trial balance here will agree. Such errors may or may not affect profits. As the trial balance agrees it is rather difficult to detect such errors. Possibilities of purposely committing such errors cannot be ruled out. Such errors may be committed to conceal some other major fraud. So, the auditor should make extra efforts to detect such errors.

All the above types of errors can be easily detected during normal audit procedure if they are not intentionally committed.

Errors may be committed by the employees due to their ignorance of the subject matter or mere carelessness.

FRAUDS

Definition:-

SA 240 defines the fraud as follows: " fraud is a an intentional act by one or more individuals among managements, those charged with governance, employees or third parties involving the use of deception to obtain an unjust or illegal advantage".

Fraud is a broad legal concept. But the auditor here is concerned with only frauds that cause material misstatement in the financial statements. Fraud may involve misappropriation of asset or only misstatement that affects the final conclusions to be drawn from the financial statements.

Though this standard speaks only about frauds and errors in the financial statements, special laws and regulations may require the auditor to follow special procedure in respect of certain types of concerns. The auditor, while planning his work, should evolve such a procedure that misstatements errors and frauds are avoided and duly corrected when detected.

Misstatements in the financial statements may arise from frauds and errors. Errors are unintentional but frauds are committed by some employee, management or some third party for deceiving somebody to gain some illegal advantage. That way fraud is a broad legal concept. Auditor is not expected to decide whether a legal fraud has been committed or not. He is only concerned with misstatement in the statement of account with fraudulent intention. If the fraud is committed by the management it is called management fraud and if the same are committed by the employees they are called "employee frauds". In both these cases, some outside parties also might have played some role. Fraud may involve misappropriation of cash or some other asset.

Here there is a misstatement or omission of an amount done purposely to deceive the users of financial statements. There may be manipulation, falsification or alteration in the account records. Fraud may also be committed by producing false supporting records or documents like bogus bills or vouchers etc on the basis of which the accounts are prepared.

Misappropriation of assets means there may be theft of some tangible assets. Payments may be made for the goods which are not actually acquired or received. Furniture, air conditioners etc purchased for office out of office funds may be actually used at home by the people in the management. False records may be prepared to conceal the facts.

Frauds are intentionally committed to gain some financial benefit. Individuals commit frauds to live a luxurious life beyond their means. Financial position of the business is shown better than what it is to deceive the new investors or lenders like banks. This is called window dressing in the technical terms. Secondly the financial position may be shown worse than what it is to encourage existing investors to sell off their shares. Profits may by suppressed to avoid Government taxes like Income Tax etc.

In fraud there is deliberate concealment of facts. Sometimes the management is under some pressure to show achievement of certain targets. When they fail to achieve these targets, they try to falsify the accounts to present a wrong financial picture.

Responsibility of Auditor for frauds and errors

No doubt the auditor is appointed to find out the errors and frauds in the accounts. It is his duty and he is paid for it. However it should be remembered that the auditor is not an insurer. We cannot say that audited accounts are free from any errors or frauds and that they are hundred percent correct.

First thing we have to remember here is that primarily it is the duty of the management to take all necessary steps to prevent frauds. Management should arrange the things in such a way that there is no scope for the employees as well as the management to commit frauds. The vary atmosphere should be such as to be deterrent to commit frauds. There should be a culture of honesty, integrity and ethical behaviour in the organisation. There should be effective internal check system and strict supervision on the staff so that nobody can venture to commit fraud. As it is said, prevention is always better than cure. Instead of spending time, money and energy, subsequently on taking action against the persons committing the frauds, it is always advisable to arrange the things in such a way that there is no scope for committing frauds. T*here should be checks and counter checks*.

However the auditor is held responsible if he is negligent in his duties. As per SA 200 the auditor shall maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist. Normally the auditor may accept that the records and evidences produced before him are genuine. However if he comes across any slightest possibility of fraud, he must go deep in to the matter to find out the truth.

The purpose of this standard is to establish standards on the responsibility to consider frauds and errors in the audited financial statements.

The auditor while planning his audit work should evolve such a procedure that misstatements, errors and frauds are avoided. Initially he must discuss the matter with the management and ask them if they suspect frauds in any particular matter.

Auditor should always remember that the audited financial statements are used by the shareholders, Government department to assess tax liability, prospective lenders like banks and other financial institutions and prospective investors. All these people believe that the statements of accounts certified by him are fully correct. So, he must try his level best to live up to their expectations.

It is the responsibility of the auditor to conduct the audit in accordance with the various auditing standards accepted in India and see that the statements of accounts are free from errors and frauds and there are no material misstatements in the accounts. Audit should act as a deterrent. However, the auditor can not be always held responsible for prevention of frauds and errors as there some are limitations of audit.

Limitations of Audit :

There are some inherent limitations of an audit. It is just possible that even though the audit is properly planned and conducted some frauds and errors may not be detected. Sometimes the frauds are carefully planned and committed and concealed by the management. In such cases they may not be easily detected by the auditor in his routine checking. An audit does not guarantee that all material misstatements will be detected. An audit may only provide a reasonable assurance. The possibilities of not detecting frauds are more than the possibilities of not detecting errors. This is because the frauds are committed intentionally after careful planning by the persons in authority. The usual audit procedures followed for detecting errors, may not be equally effective in detecting such frauds. As we have seen earlier, frauds may be committed by the employees, management and even by some connected third parties. Between the frauds by the management and the employees it is easier to detect those committed by the employees than those committed by the management. If material misstatements are subsequently detected in the account statements, it cannot be concluded that the auditor has not properly planned his work or he was negligent in his duties or he is incompetent or auditing standards have not been complied with by him. In other words, in spite of the auditor doing his job, carefully following the normal audit standards, the possibilities of errors and frauds in the statements, cannot be completely ruled out. Still the auditor should not always proceed with a presumption that in every statement, there are bound to be errors and frauds and that everybody dealing with the accounts is a crook. He must start his work with an unbiased attitude. That is why the auditor is described as a watch dog and not a blood hound. He should generally go ahead in his work on the assumption that all the documents produced before him are genuine. However, if he comes across any slightest suspicious matter, he must go deep in to the matter and use all his experience and skill to find out whether there is really any fraud committed in the accounts. Still an audit is not intended and cannot be relied upon to disclose all irregularities in the accounts. However, on his part the auditor should do his level best to ensure that all frauds and errors are discovered. The auditor is required to conduct the audit by exercising reasonable care and skill. He will be held liable only if he failed to exercise reasonable care and skill expected from a man of his calibre. Auditor's performance is tested on the following criteria. He will be held responsible only if

(1) He has not exercised reasonable care and skill or
(2) There was room for suspicion and still the auditor did not go deep in to the matter to find out the truth, or
(3) He was not followed the normal audit procedure.

Auditor will not be held responsible, if he proves with the help of his working papers that he has followed adequate procedures and that the errors or frauds were carefully concealed.

If the auditor has identified a fraud, he should communicate the same to the concerned persons in the management. If their response to it is not reasonable he should even decide to withdraw himself from the assignment. He must resign immediately and convey his reasons for doing so to the management and in case of joint stock company even to the shareholders who are the real owners of the company. If then the management appoints a new auditors in his place, such new auditor is expected to communicate with the previous auditor before accepting the assignment as per the professional code of conduct prescribed by the Institute of Chartered Accountants of India. At that time, the auditor should frankly convey to the new auditor his real reasons for withdrawing from the assignment.

CHECK YOUR PROGRESS:-

(a) Meaning and kinds of errors
(b) Frauds
(c) Difference between the errors and frauds
(d) Auditor's responsibilities in case errors and frauds
(e) Limitations of audit

6.4 AUDIT STANDARD 300 (PLANNING AN AUDIT OF FINANCIAL STATEMENTS.)

A simple definition of planning is thinking in advance or thinking before doing. Planning is necessary, in all works of life and auditing cannot be an exception. Planning or thinking before doing, helps us in a number of ways. When we think in advance, we can collect all necessary men and material to complete the job. We can think in advance about the problems likely to arise while doing the job and think out the solution for these potential problems. We can decide the time schedule for the job and complete it in time as per the time table prepared. It its said that pre informed is pre armed. So, if we know in advance the possible difficulties we are likely to face, we can consult outside experts and discuss with them the problem. If the work is planned in advance, th quality of the work is also likely to better.

Definition of Audit Planning:-

This standard on audit deals with the preparation of audit plan by the auditor. This AS came into effect from 1st April,2008.

Audit planning is defined as planning by the auditor to enable him to conduct an effective audit in an efficient manner. It includes planning about area, scope, depth of transaction to be audited, time to be devoted, persons to be deployed for audit etc.

AS 200 which deals with the basic principle of audit states that the auditor should plan his work to conduct an efficient audit in an efficient and timely manner.

Process or procedure for Audit Planning:

To begin with the auditor should visit the client's office and factory if any and collect full information about the nature of the business and process of manufacture. This information will be very useful to him while doing his job. Then he must familiarise himself with the different laws governing the client's business. Auditor's knowledge about these laws and other regulations regarding this business should be up to date. Then the auditor should study the accounting method followed by the client and note down the names of different officers and their duties. This information is very important because, if he comes across any problem during the course of audit, he can discuss it with the concerned official directly. Auditor should also study the internal control system prevalent in the organisation and on the basis of his knowledge and past experience, decide how far this system is effective and to what extent he can rely on it. If there is an internal auditor for the firm, he should collect information about his duties. This will help him to decide whether it is necessary to check each and every item or he can adopt the system of test check, and thoroughly check few items selected at random. With complete information about the business, he should proceed to prepare a plan.

He should then assess the amount of total work to be completed and how many persons are necessary to complete the work as per the time schedule. After deciding the required number of staff, he should identify the particular persons from his staff, ‘who are to be deployed for this work. Then the work to be completed is distributed amongst the designated staff. In allotting the work to different members of the staff, he should take in to account the qualifications, experience and capacity of each staff member and then allot to him the necessary job. Personal likes and dislikes of the staff, in doing different types of work should also be taken in to account.

Then he must prepare a time table and allot time for each work and direct the members of the staff to complete the work allotted to them in the given time. First he may fix dates for different part of the work to be completed and then divide the time amongst the staff and ask them f\to complete each part of the job as per the time table.

Such a detailed time table or audit plan is an important document and should be carefully preserved.

The plan prepared should not be rigid or unchangeable. It should not be treated as sacrosanct. As and when there are major changes in the circumstances, he should suitably alter the plan. Though the plan is to be prepared before the commencement of the work, the auditor should see to it as a continuous process throughout the audit engagement. Before finalising the plan, the auditor should discuss it with his staff and carefully consider the suggestions if any, made by them, as finally the success of the plan will depend upon the performance of the staff only. Secondly the auditor should also discuss the plan schedule with his client and take in to account the convenience of the client, because, co-operation of the staff of the client is necessary throughout the process of audit.

The objective of the auditor in preparing such plan is to complete the assignment in an effective manner. An auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit. He should ascertain the objectives of his engagement.

On the basis of his past experience he should decide the important points where frauds and errors are likely to be committed. Then he should direct more attention on those points. More detailed scrutiny of such items must be done.

The audit plan should also provide for effective supervision on the work of the subordinates. Their work should be reviewed by the partners in the firm from time to time.

The nature and extent of planning will depend upon the size and complexity of the business of the client.

The auditor should take in to account last year's plan and taking into account the changes in the size and nature of the business during the current year, modify the previous year's plan and make it suitable for the current year.

Initial Audit Engagement:-

When the auditor takes up the assignment of audit of an entity for the first time, he must spend more time on understanding the nature of the business of the firm. Here he must follow the procedure prescribed by SA 220 regarding the audit engagement like sending a letter of engagement containing in detail all terms and conditions, the actual work to be done conditions of his appointment, his duties and method of calculation of his fees etc. and get it approved by the client.

Secondly, as per the rules prescribed by the Institute of Chartered Accountants as code of conduct for its members, the auditor should contact the earlier auditor and seek no objection certificate from him. This is the normal practice followed by all chartered accountants. Every auditor should meticulously follow this procedure, every time he accepts a new assignment which was audited earlier by a different person. If he fails to follow these rules,. The institute may initiate action against him for the breach of code of conduct.

We have number of laws applicable to different industries and audit reports to be prepared for different industrial units also vary. So, the auditor should know all these different laws and amendments to them from time to time. He should prepare the audit reports accordingly. The auditor should take into account these different t laws while preparing the audit plan. If necessary an auditor should take the assistance of different experts from outside. He must assess the high risk areas and deploy more qualified and experienced staff to do that job. The auditor has also to fix the sequences of the different procedures to be followed i.e. which work should be done first and which one next etc and follow it.

Audit of smaller entities:

The procedure of audit and the total work to be completed will depend upon the size of the unit. So, naturally in the case of the audit of smaller entities, the entire audit may be conducted by a very small audit team. As the team here is small, co-ordination and communication between the team members is rather simple. Planning for such audit may not require more time. Time for planning will always depend upon the size of the unit. A short discussion with the owner and slight modification here and there of last year's audit plan may suffice.

Audit of larger concerns:

In the case of larger concerns, a detailed plan may have to be prepared. So the number of the staff doing the job will also be more. Here frequent meetings of the staff may have to be held to co-ordinate the work of different members.

Change in the plan:

Sometimes, during the course of audit there may be changes in the condition. New evidence may be produced and change in the audit plan and audit strategy may be found necessary. Time schedule decided may also be required to be changed. The auditor may come across new information during the course of audit. Conclusions drawn earlier may have to be altered or amended accordingly.

There is need for direction supervision and review of the work done by the junior staff from time to time. If the partner of the firm of chartered accountants is personally auditing any particular business entity, then there is no need for any supervision and review of work as he is duly qualified and expert in his job. The question of supervision and review arises only when the job is assigned to the junior staff or articled clerks.

Documentation:

During the course of audit the auditor should collect and preserve the following documents:

(1) The detailed audit plan
(2) Key decisions taken during the course of audit
(3) If the audit plan is subsequently altered, the auditor should record in writing the reasons for such changes.

Advantages of preparing an Audit Plan:

(1) Planning helps the auditor to devote appropriate attention to important areas of the audit.
(2) Solutions may be found out in advance
(3) Audit work can be organized and managed in an efficient manner.
(4) Audit assignment can be completed in time

(5) The staff is fully and properly utilised
(6) There is proper co-ordination between the work of different assistants
(7) An audit programme is a good tool. *For effective delegation of work to assistants.*

Audit programme would be prepared for each major area like verification of fixed assets and inventories, debtors and creditors etc. In the case of debtors the auditor should confirm that they actually exist. For what he should send confirmatory requests for all high level debtors. Its is necessary to verify inventory and cash balance of the last working day. But to do so at each and every place, may not be physically possible. So, he must do it before or after the year end as per his convenience and a roll forward or roll backward as the case may be should be performed.

CHECK YOUR PROGRESS:

(a) Need for planning.
(b) What is an audit plan?
(c) What are its advantages?
(d) What is the procedure of preparing the plan?

6.5 SUMMARY:

In this chapter you have studied the following three standards on auditing.

(1) SA 230 on audit documentation.
(2) SA 240on auditor's responsibilities relating to frauds and errors in an audit of financial statements.
(3) SA 300planning an audit of financial statements.

Documentation:

Documentation means working papers prepared and collected by the auditor during the course of his audit procedure. They help the auditor in the planning and performance of audit. Documents are to be carefully preserved. They include audit plan, audit procedure, important conclusions drawn, evidences obtained etc. They are useful to the auditor to defend himself in the court if any case is filed against him in future for negligence. They are classified in to permanent and current audit files. They are the property of the auditor.

Auditor's responsibility for frauds and errors:

Frauds are purposely committed to gain some illegal benefit. Errors are unintentional. Detecting them is the duty of the auditor. However the primary duty of avoiding them is with the management. Management should arrange for proper internal check system to avoid frauds and errors. However, the auditor will be held responsible for them if he has not followed the normal audit procedure and he is found to be negligent in his duties. There are inherent limitations of audit.

Audit Planning:

Audit work should be properly planned in advance. Auditor should first study the nature of the business of the client. Required number of suitable staff should be deployed for the work. The volume of work should be properly distributed amongst the assistants, taking in to account their capacity, knowledge and experience. Auditor should give them proper direction and supervise and review their work from time to time. Plan once prepared should be suitably altered if there is change in the circumstances or new evidence comes to light. Auditor should also prepare a time budget and follow the implementation of the time budget from time to time.

6.6 QUESTIONS:

1. What is documentation? Why is it required?
2. Who is the owner and custodian of working papers?
3. What is a permanent and current audit file and what documents they should contain?
4. Define fraud and errors and set out difference between the two with examples
5. Whose primary responsibility is it to detect frauds and errors?
6. What is the auditor’s responsibility to prevent and detect frauds and errors?
7. Why is audit planning required? What are its benefits?
8. What are the factors considered by the auditor while preparing the audit plan?
9. Fill in the blanks.
   a. SA 300 deals with ________.
   b. SA 230 is in force from _______.
   c. Working papers are classified into (i) ______ (ii) ________.
   d. Audit plan is prepared ______ the commencement of the audit.
10. Write short notes on
    a. Audit note book and.
    b. Audit of smaller entities.

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7

THE STANDARDS ON AUDITING 500, 501 AND 505

Unit Structure

7.0 OBJECTIVES

After studying the unit the students will able to understand:

- Definition of Audit Evidence as per SA 500 (revised).
- The procedure of checking the correctness of the evidence produced before the Auditor as per SA 500.
- Relevance and Reliability of the evidence as per SA 500
- Audit evidence-specific considerations for selected items as per SA 501 revised.
- Definition of SA 505 revised.
- How to design the letter of request for confirmation.

7.1 INTRODUCTION:

In this chapter you will be studying next three standards on auditing namely SA 500 (Revised), SA 501 (Revised) and SA 505 (Revised). All the three standards are concerned with different types of audit evidences used by the Auditor during the course of his audit. Now let us consider them one by one.

7.2 SA 500: AUDIT EVIDENCE

The Auditor has to audit the annual statements of accounts and certify that they reflect the true and fair picture of the state of affairs of the concern. For this he has to follow a prescribed audit procedure.

The Auditor should obtain sufficient, relevant of appropriate and reliable evidence on the basis of which he can draw reasonable conclusions regarding the account statements.

To begin with the Auditor should get assurance from the management that effective internal control is in operation throughout the year. He should also ensure that all assets and liabilities actually exist on the given date. He should also insist that the assets in existence are valued on some generally accepted normal lines.

Definition of Audit Evidence:

Audit evidence refers to any information, verbal or written, obtained by the Auditor, during the course of audit to arrive at the conclusion on which he bases his opinion on financial statements. E. g. sales invoices, purchase invoices, bank balance certificate issued by the bank, correspondence with third parties etc are examples of evidences.

Here, one thing should be clearly understood that audit evidence is different from proof. While following the audit process, the Auditor persuaded himself by gathering different evidences from different sources at different times under different circumstances. The purpose of collecting such evidence is to verify to what extent the assertions made by the management are valid. Therefore the audit process is called process of persuasion rather that process of proof. An example will clarify the above discussion. Suppose, the firm has purchased some furniture for the office, the Auditor will verify the same with the purchase invoice received from the furniture vendor. Purchase invoice is only evidence and not the final proof, because it is just possible that the furniture might not have been actually purchased. For confirmation of this transaction the Auditor should personally physically verify the existence of the furniture in the office of the client. That is the final proof.

This standard explains what constitutes evidence in an audit of financial statements. The Auditor is expected to collect and verify sufficient evidence to form his opinion about the financial statements. This SA deals with evidence in general. It is applicable to all evidences. Besides, there are other standards which deal with specific aspects of the audit.

This standard is made effective from 1st April, 2009 in its revised form.

It is obligatory on the part of the Auditor, to collect sufficient reliable evidence, before forming his opinion on the correctness of the financial statements. During the course of audit, the staff of the client will produce different document to the Auditor in support of the entries in the books of accounts and financial statements. It is the duty of the Auditor to evaluate their reliability and sufficiency. Sometimes, the Auditor is doubtful about the evidence produced before him or information collected by him from different sources is not the same, then the Auditor should collect additional and corroborative evidence from some other source by making further detailed enquiries and get himself convinced about the correctness of the information.

Audit evidence is necessary to support the opinion formal by the Auditor and the report submitted by him. It is primarily obtained during the course of audit. He may also obtain some information from the audit report of the previous year. Accounting records are an important source of audit evidence.

Audit procedure consists of obtaining and evaluating audit evidence. There should be inspection of the audit evidence produced. Auditor should conduct necessary inquiries to assess the correctness of the evidence. There should be inspection of the audit evidence produced.

Evidence produced should be:

(1) Sufficient in quantity
(2) Should be appropriate and
(3) Should be true

(1) Sufficient in quantity:

On the basis of his past experience the Auditor should decide the risk involved in each case *risk involved will decide the quantity of evidence* where there is more risk, more evidence should be collected. However, as it is always said that quality is more important than quality. So the quantity of evidence is not the only criteria. It is more important that it should be of good quality. Reliability of the evidence depends upon its source. The Auditor should express his opinion only when adequate and quality or satisfactory evidence is produced before him.

The Auditor can study the records produced before him and prepare certain statements to check whether the records are internally consistent and agree with the financial statements. Evidence should always be collected from different sources and it should tally with each other. The Auditor can go through the accounting records, minutes of the meetings of directors or their committees etc to check and recheck the genuineness of the evidence. Some information may also be confirmed by the third parties. E. g. balances of debtors and creditors. The Auditors may send statements of their accounts to selected creditors and debtors and request them to confirm the correctness of their balance directly to them.

Some evidence may be available in electronic record. Electronic record may or may not be retained for a longer time. So, the Auditor should ask the client to wipe it off only after his inspection of the same. He may ask his client to take his permission, before wiping out the information from the computer.

To check the correctness of the evidence produced before him, the Auditor may adopt the following steps:

(1) Inspection
(2) Observation
(3) External confirmation
(4) Recalculation
(5) Re-performance
(6) Analytical Procedures and
(7) Inquiry

Now let us consider these points one by one:-

(1) **Inspection:-**

Records and documents, in any form, whether internal or external, in paper form, electronic form, or other media should be carefully inspected by the Auditor. In the case of tangible assets like machinery, cash etc, they should be physically verified. Mere inspection of the documents may not be a conclusive evidence of their existence.

(2) **Observation :-**

Observation consists of looking at a process or procedure being performed by others for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.

(3) **External Confirmation**:-

In the case of debtors' and creditors' balances, the Auditor should send copies of their accounts to respective persons and ask them to confirm their correctness or otherwise directly to him. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition.

(4) **Recalculation:-**

Client's staff might have made some calculations and prepared and presented some documents to the Auditor. Mathematical accuracy of these documents may be checked by the Auditor by himself, by making these calculations one again.

(5) **Re-performance:-**

Client's staff might have prepared some documents like list of closing stock etc. Auditor may follow the same procedure independently to check their accuracy. He need not accept such documents presented to him, as they are presuming that they must have been prepared correctly.

(6) **Analytical Procedures:-**

Analytical Procedure consists of evaluation of financial information and investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(7) Inquiry:-

It means seeking information from knowledgeable persons within or outside the entity. It is used throughout the audit procedure. Inquiries may again be of two types, written or oral. These responses to the inquiries are then evaluated by the Auditor. Such inquiry may provide fresh additional information or it may confirm the information already collected.

Relevance and Reliability of the evidence:

The evidence collected by the Auditor should be relevant and reliable. Relevance mans there should be logical connection with the purpose of the audit procedure. Reliability of the evidence mainly depends upon its source and nature. Reliability increases when it is obtained from independent outside sources. Evidence directly obtained by the Auditor from the third parties is more reliable than the one obtained indirectly. E. g., balances confirmed by the debtors and creditors. However, documents prepared by the third parties but presented by the client like suppliers invoices etc may not be as reliable as those confirmations directly received by the Auditor.

Then evidence in documentary form is more reliable that the one obtained orally. E. g., minutes of the meetings are more reliable than subsequent oral representation of the matters discussed in the meeting. Again, original documents are more reliable than photo copies.

Persons preparing different accounting statements should be well versed in their job. They must be thoroughly conversant with the subject matter and experts in preparing such statements. Estimates should be made only by experts in their respective fields.

Reliability of the evidence may be verified either by an expert employee or by an outside independent expert. Outside expert is always likely to be less under the pressure of the management than an expert employee. So, the Auditor should insist upon verification of the evidence by an outside expert so that the opinion given is unbiased. The expert who is assigned the job should not have and personal interest in the matter.

The management of the entity should supply correct and complete information to the Auditor.

The Auditor may audit each and every item i.e. 100% check or select specific items. He may also adopt random sampling method. The Auditor will take a decision about this matter after studying the internal check system prevalent in the organisation. If the Auditor is convinced that the internal check system prevalent in the organisation is sufficiently effective, he may adopt test check system. Otherwise he may adopt 100% checking. Secondly if the number of items is small and they are all of large value, he may resort to 100% checking. Alternatively, the Auditor may select high value or key items only for verification. Unusual or suspicious items should always be selected for checking.

Audit evidence may be collected internally like goods received notes, sales invoices etc or from outside like purchase invoices of Insurance policy, bank balance certificate issued by the bank etc. Examples of visual evidences are cash in hand, fixed assets etc.

Internal evidence may not be as reliable as external evidence. Reliability of the internal evidence depends upon the effectiveness of the internal control system. In the case of suspicious circumstances the Auditor should insist upon more compelling and corroborative evidence to remove the doubts in his mind.

For testing the correctness of the evidence, the Auditor may make use of ratios and trends. In the case of bank reconciliation statements the Auditor should ensure that there is segregation of duties between the preparer of the bank reconciliation statement, cashier and book keeper. Such statements should be prepared promptly and regularly at the end of the period. The outstanding items must be cleared regularly at an early date.

The Auditor may gain increased assurance when the evidence is collected from different sources. There should be no inconsistency between the evidence collected from different sources. If the management depreciated the assets at a particular rate and the rate is the normal rate followed by all units in the industry, the Auditor need not bother. However if the rate of depreciation followed by his client is different from the normal rate followed in the industry, the Auditor should probe deep in to matter and find out the reasons for the departure from the normal practice. If he is satisfied by the reasons given it is alright. Otherwise he must ask the client to make necessary changes.

Finally, if the Auditor is not satisfied by the evidence produced before him, he should not give a clean report. He should be bold enough to give a qualified report.

Thus in short the Auditor should insist on sufficient, relevant and correct evidence.

CHECK YOUR PROGRESS:-

1. What is evidence?
2. Explain the following:

a. Adequacy of evidence
b. Relevance of evidence
c. Correctness of evidence

7.3 SA 501: AUDIT EVIDENCE – SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

Audit evidence-specific considerations for selected items:

The earlier standard SA 500 that we have studied deals with audit evidence in general. It is applicable to all types of items in the financial statements. This SA 501 deals specially with four important items in the financial statements. Application of this standard and the guidance provided in it will assist the Auditor in obtaining sufficient audit evidence in respect of these four important items in the financial statements. Thus the SA 501 is divided in to four parts:-

Part A. Attendance at physical inventory counting.
Part B. Inquiry regarding litigation and claims.
Part C. Valuation and disclosure of long term Investments
Part D. Segmented Information.

Let us now deal with these items one by one:

Part A. Attendance at physical inventory counting:

Inventory or closing stock constitutes one of the major items in the financial statements. So, the Auditor should collect sufficient satisfactory evidence about the same by :

(1) Evaluate management's instructions for recording of inventory.

(2) Observe the performance of management's count procedures.

(3) Inspect Inventory

(4) Perform Test Count.

Closing stock may be of three types:

(1) In the case of dealers, it will be the unsold stock or stock ready for sale.

(2) In the case of a manufacturer it may consist of three items viz stock of raw material to be used in production, partly finished goods or work in progress and finished goods.

(3) In the case of service units, it may be stock of material used in providing the service e. g. In the case of a garage it may be oil, soap etc.

There are two systems of valuation of stock.
(1) Periodical inventory system and
(2) Perceptual inventory system.

Under periodical inventory system stock is generally valued at the end of the year or as near the same as possible. Sometimes it may not be possible for the business unit to value the inventory on the last working day only. In that case, the same should be valued a few days earlier or a few days later as per the convenience of the unit.

In the case of perpetual inventory system, there are bin cards and the different items of stock are verified or physically counted and tallied with the book figures from time to time. If there is any difference between the two, a suitable adjustment is made and the causes for the difference are investigated if found necessary i.e. the difference is more.

Some business units use both the systems at the same time. For some items of inventory, perpetual inventory system is used and for others the periodical inventory system is adopted.

Whichever method is used, the Auditor should study the details of the system and see whether there ate any loopholes in the same. Before actual stock taking process starts, the management should evolve a procedure for the same and give complete detailed instructions to the staff. In preparing these instructions, the management may seek the advice of the Auditor. In other words these instructions should be prepared in consultation with the Auditor and issued to the staff in writing. The staff which takes stock should be different from those dealing regularly with the accounting of the inventory, to avoid possibility of frauds. The Auditor should see that these instructions are being meticulously followed by the staff. While counting the stock, slow moving and obsolete stock should be separated from the regular stock and valued appropriately. Sometimes some stock may be under the control of any other party. E. g. goods on consignment or goods in transit etc. In that case, the Auditor should insist on written confirmation from these persons about its existence and condition. He should verify the documentary evidence like warehouse receipt etc. Goods sold but not delivered should be excluded and goods purchased but still not received should be included.

When stock taking work is in progress, there should be preferably no movement of stock. If production process cannot be stopped and movement of goods is absolutely necessary, the Auditor should keep a special watch on such movements.

The Auditor should attend personally and watch the process of stock taking. If he cannot attend due to any unavoidable circumstances he should attend as early as possible and assess the correctness of the valuation. He may make physical verification of some of the stock at random and get himself convinced that the set out procedure has been correctly followed.

In some cases, the stock may be at different location. Then the Auditor should attend at any one place. This selection of place, should be done by him on the basis of the value of the material at different places, internal control system prevailing and possibility of fraud. He may also ask some other Auditor to attend at other places, if possible.

In short, he should see that there is reliable system of recording movement of stock.

In some cases, the quantity may be only estimated and not actually weighed or counted e. g. a coal pile. Here the Auditor should be satisfied that the procedure adopted for estimation is reasonable.

There should always be cross checking. For counting the stock, pre-numbered standardised printed forms should be used.

The Auditor has to mainly check 3 things:

(1) All recorded inventories actually exist on that day and are in proper condition.

(2) They are owned by the client.

(3) They are valued on some sound accounting principles.

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

Physical verification of inventory is primarily the responsibility of the management. However, in view of the importance of it in the financial statement the Auditor should also collect as much satisfactory evidence about the same as possible. He should obtain a written representation from the management regarding completeness of information about inventory and that prescribed procedure has been followed for its physical count.

If the Auditory fails to set satisfactory evidence about the inventory he should mention this fact in his report. He should issue a qualified opinion or give a suitably qualified report.

Part B. Litigation and Claims:

The auditor shall perform procedures to identify litigation and claims which may give rise to risk of material misstatement. He shall inquire the management, review the minutes of meetings of the board members and the external legal team and also review the legal expense account.

Litigation and claims against the business may have material effect on the financial statements. So, the Auditor should collect sufficient and reliable evidence about the cases pending in different courts, either filed by or against the firm and their financial implications.

The Auditor should discuss the position of the different cases regarding the unit with the legal department of the business if any or with the lawyers of the entity. He may meet the lawyers of the entity with the permission of the management of the concerned firm and take with him a representative of the firm and discuss with them the actual position of the pending cases for or against the firm. He must also discuss with them about their estimates of the financial implications of these pending cases.

Normally, clients permit the Auditor to discuss the matter with their lawyer. However, if the client refuses such permission, it gives room for suspicion and the Auditor should mention this fact in his report.

The Auditor should take a written statement from the management about all cases concerning the unit, pending in different courts up to the date of his report, their exact position and estimate of the management about their financial implications. The Auditor should carefully scrutinise the legal expenses account of the firm also.

Part C. Valuation of long term investments.

Long term investments are material to the financial statements. So, the Auditor should obtain sufficient and appropriate audit evidence regarding their valuation.

Definition:

There is a negative definition of the term long term investment.

Current investment is the investment which is readily realisable within a year. All investments other than current investments are long term investment. In other words investments which are for more than one year are classified as long term investments.

Investments constitute a significant portion of the total assets of certain entities like banks, insurance companies, investments companies, etc. A detailed record of their acquisition and disposal should be maintained. Their market value may keep on fluctuating. Investment should be owned by the client and not held on behalf of others. This fact should be confirmed by the Auditor.

The Auditor should study the internal control system relating to their acquisition and disposal. Legal requirements should be strictly followed. They should be properly protected.

The Auditor has to verify their physical existence and ownership. Sometimes they may be deposited with some third party like banks for safe custody. In that case, the Auditor should obtain a written a statement from the bank about their existence. The Auditor should also verify whether they are kept with the bank for safe custody or mortgaged for obtaining loan.

Valuation:

Valuation of quoted investments creates no problem. Market rate of these investments on the date of the financial statements can be taken as their value. However, valuation of unquoted investments is rather difficult. They may be valued by the client on some generally accepted principles like (a) profit earning capacity method (b) break up value method (c) capitalisation of yield method (d) yield to maturity method etc. the Auditor has to see that the method of valuation adopted by the client is reasonable and consistently followed year after year.

In the case of investments other than in the form of securities, their market value may be taken. Wherever necessary, services of expert valuers may also be sought.

If the Auditor is of the opinion that realisable value of the various investment, is less than the one shown in the financial statements, the Auditor must insist on suitable adjustment in their value or make necessary provision in the accounts about possible reduction in their value. If the management refuses to make such provision, the Auditor should frankly express his opinion in his report.

Finally the Auditor should obtain statement in writing from the management about the completeness of the information provided by them regarding valuation and disclosure of long term investments and the adequate provision has been made for diminution of their value wherever required. He should also take a statement from the management that it intends to continue to hold these investments as long term investments only.

Part D. Segment Information:

There should be appropriate disclosure of segment information. So, the Auditor should perform audit procedures and obtain appropriate audit evidence for proper disclosure of segment information.

AS 17 issued by the Institute of Chartered Accountants has prescribed the information to be disclosed in respect of different segments in the financial statements. The Auditor should confirm that all such information is disclosed in the account statements prepared by the management such segment information is important in financial reporting of many entities. So, the Auditor should collect sufficient and appropriate audit evidence in this respect. Segment means parts.

He will consider segment information in financial statement taken as whole. Sufficient audit evidence is necessary in this respect to enable the Auditor to form his opinion. Audit procedures in respect of segment information generally consist of analytical procedures and other appropriate audit tests.

He will discuss with the management the method used by it in determining segment information. There should be proper financial disclosures. The Auditor would consider sales, transfers and charges between segments. Inter segment amount should be eliminated. Budgets and expected figures should be compared. E. g. operating profits as a percentage of sales. These figures are also compared with the figures of the earlier years. There should be adequate disclosure and consistency with the earlier figures.

As in respect of other matters, here also the Auditor should take a written representation from the management about the completeness of information regarding segments and disclosure there of, appropriateness of the segments selected often risks and returns and the organisational structure of an enterprise. If there is any deviation by the management in its financial reporting policy, it should also be mentioned with the reasons for such deviation or change.

Finally, if the Auditor fails to collect appropriate audit evidence in this connection and is not fully satisfied, the must frankly mention this fact in his report.

Effective for all audits relating to accounting periods beginning on or after April 1, 2010

Mostly our standards on auditing are similar to the international standards. However in case of this standard there are differences between the two on following two points:

(1) In case of pending litigation, under Indian standard the Auditor may or may not discuss the matter with the company's lawyers, however, under international standards, such consultation is compulsory.

(2) Under Indian standard, each part of the SA requires written representation from the management about its compliance. There is no such requirement under the International Standards (ISA).

CHECK YOUR PROGRESS:

- Explain the following

1. Attendance at physical inventory
2. Litigation and claims
3. Valuation of long term investments
4. Segment information

7.4 SA 505: EXTERNAL CONFIRMATION

This standard is an extension of standard 500. SA 500 which deals with audit evidence in general states that the reliability of the audit evidence is influenced by its source and nature. It indicates that audit evidence from external source is more reliable than the audit evidence generated internally. Secondly written or documentary evidence is more reliable than the audit evidence in oral form. Considering all other circumstances and estimating the risk involved, the Auditor should decide whether the external confirmation is necessary in a particular case.

This standard deals with the use of external confirmation as a means of obtaining audit evidence. On the basis of his past experience, the Auditor has to decide whether external confirmation is necessary in a particular case to support certain evidence collected from other sources. This method is used only in the case of certain important type of items in the financial statements and the Auditor is not completely satisfied with the internal control system prevalent in the unit. The Auditor should adopt this system only in consultation with the management and with its permission.

Written confirmation from the third party is always more reliable evidence as they are not related to the unit. Such third party has no personal interest in the matter. The information provided is likely to be comparatively more correct and reliable and unbiased.

Definition:-

External confirmation is the process of:

- ❖ Obtaining and evaluating audit evidence
- ❖ Through a direct communication
- ❖ From a third party
- ❖ In response to a request for information about a particular item
- ❖ Affecting assertions made by the management in the financial statement.

Written confirmation from the third party is more reliable evidence as they are not related to the unit. Such a method will reduce the risk of the Auditor.

The Auditor here writes to the third party and requests the same to send its unbiased frank opinion on a particular point. The third part is requested to send his reply, directly to the Auditor and not through the client. This will ensure that the third party expresses its opinion frankly. For obtaining such confirmation, the Auditor selects certain items which are important or material from his point of view. Normally large and unusual items from the financial statements are selected for confirmation. Usually, such confirmation is sought in a particular form sent to the party. A letter is sent to the third party and he is requested to send his confirmation when such information is received by the Auditor, he evaluates it on the basis of his professional scepticism and past experience in the field of audit. This method is normally used in the following cases:-

(1) Confirmation of balances in the accounts of debtors and creditors or accounts payable and account receivable. They may also be asked to send the details of all or some major transactions.

(2) Banks are requested to confirm the balance in the client's account.

(3) Stock held by others like goods in the hands of the consignee or goods in the custody of the seller who has not yet delivered them. etc.

(4) Title deeds of properties with the third parties. The client may keep the title deeds of properties in a bank locker for safe custody or he may borrow money from a third party by depositing such title deeds with him.

(5) Investments purchased but not delivered. They may be in the custody of the broker or seller.

(6) Balance of loans from the lenders.

(7) Long outstanding share money.

(8) Terms of agreement with the third parties, etc.

If the Auditor is of the opinion that the internal control system is not fully reliable, he has to collect additional audit evidence to be convinced about the correctness of the figures in the financial statements. In such cases external confirmation may provide such more reliable additional evidence.

Designing the letter of request for confirmation:

To get reliable information promptly from the third party, the Auditor should design a proper form for request. The Auditor should carefully design or prepare such letter of request for confirmation. The language to be used should be simple and the letter should be to the point. It should only seek such information, which is readily and conveniently available to the other party. The Auditor should prepare such a letter in such a form that the recipient has to make minimum efforts to reply the same. He may have to fill in minimum words in such a letter for reply. To facilitate his work, the Auditor should enclose a self addressed envelope. Arrangements can also be made with the post office to post the letter without any Retain postal stamp. Postage will be paid by the addressee i. e. the Auditor when he receives such a letter.

The Auditor should take in to account the characteristics of the respondents. External confirmation redresses the inherent risks in the internal control system.

The Auditor should use this system selectively only where he finds it absolutely necessary. It should be invariably used for unusual or complex transactions only and not for simple and minor transactions.

The Auditor should use all his intelligence and past experience to draft such a letter so that he can get all necessary information from the third party. His aim should be to get maximum response from the third party to his letters.

In designing such letter of request for confirmation the Auditor should consider the nature of information the other party will be able to confirm readily. This will increase the response rate and also the nature of the evidence obtained. E. g. sometimes confirmation of a single transaction may be sufficient and the entire account balance may not be necessary. Secondly sometimes the respondent may be reluctant to confirm the entire or total transaction.

<u>The fact that permission to seek such information has been obtained from the client should be invariably and prominently mentioned in the letter. If there is no such mention respondents may not respond readily or not respond at all.</u>

The Auditor should also consider the competence of the respondents. Certain parties may not provide an objective or unbiased response. So, he should design his request in such a way that the maximum number of persons will be able to respond.

It should always be remembered that if the respondent is economically dependent on the client, he may not provide reliable information.

If the management refuses the Auditor to send a confirmation request :

If the management refuses the auditor to send external confirmation, then;

(1) The Auditor shall inquire reasons provided by the management for the refusal and seek audit evidence for their validity. He shall also evaluate the implications of the refusal for

sending external confirmations for risks of fraud or risk of material misstatement.

(2) The auditor can also design and perform alternate procedure to obtain relevant audit evidence.

Positive and Negative Response

Letters of confirmation may seek positive or negative response.

(1) Positive Response:

Here the respondents may be requested to confirm all information give by the management in the financial statement on a particular point. Alternately a form may be sent which is to be filled in and returned. However such form should be so designed that the respondent is expected spend very little time to fill the form. E. g. he may be just asked to tick mark or score out certain words. This is called positive confirmation. Positive confirmation is likely to provide more reliable evidence. The system of filling in the blanks may not get ready response as the party has to take more efforts. Tick marking system is comparatively easy.

(2) Negative Confirmation:

Here the respondent is asked only to reply, if he disagrees. Here the Auditor has no guarantee that the other party has actually verified the correctness of the information. So, such negative confirmation provides less reliable evidence than the positive response system. So, this system may be used only when the risk of misstatement is less or there are large numbers of small items to be confirmed. In short the Auditor will use this method only when he is fairly satisfied with the state of affairs.

Secondly, here the Auditor may not know exactly, whether the party received the letter or he received it but just neglected it. So the Auditor should also use other audit procedures and try to collect more evidence or corroborative evidence.

Positive and Negative or combination of the two:

Some Auditors use both the systems at the same time, when there are large number of small items and small number of big items and both are to be confirmed. He may use negative method for the large number of small items and the positive method for small number of big items. Thus combination of the two is a better way.

Limitations:

External confirmation system has also certain limitation. Its usefulness varies for different types of transactions. E. g. the

Auditor can send a letter to a debtor and receive from him the confirmation of the correctness of the balance. However, he cannot confirm the quality of the debt i.e. possibility of its recovery. He cannot ask the debtor whether he will surely clear his balance fully. Similarly if the goods are with the third party, the Auditor can write a letter and confirm the existence of these goods with him. But he cannot confirm the correctness of the valuation of these goods. For these things, he has to believe in the correctness of the valuation made by the client only.

The Auditor cannot also verify whether there are any unrecorded liabilities. For detecting such omissions, one way out is to send confirmatory letters not only to the supplier who have a balance in their account on the date of the financial statement but to all regular suppliers of the client, even if there is no balance due to them on that day. Such people also may be requested to supply a copy of the account of the client in their books directly to the Auditor.

Timing:

The date of confirmation of balance is usually the last working day i.e. the date on which the financial statements are prepared. Alternately, the Auditor may choose any other date as near the last date as possible. However, in such cases, the Auditor should verify carefully the transactions after that date or up to that date.

However, the Auditor can also choose some other date for confirming the balanced in the accounts of debtors and creditors and introduce a surprise element in the process.

External Confirmation Process:

The Auditor should have full control over this process. He should select the names of the persons to whom confirmation, letters are to be sent. He should also prepare the draft of the letter to be sent and supervise the process of sending letters and receiving the replies. The letters should be properly addressed and duly stamped. Replies should be directly received by the Auditor and even the undelivered letters should be returned to the Auditor. He should make necessary enquiries and find out the real reason for their non delivery. Where there is no response, the Auditor should send one or two reminders.

If there is oral response, it should always be recorded or documented by the Auditor in his working papers.

If the confirmation is received on Fax, it is not easy to detect the source from where it is received. So, the Auditor should confirm the same on phone with the concerned party. Sometimes the management may request the Auditor to not to send letters of confirmation to certain parties. The Auditor should ask the management to put in writing the reasons for such action. If he is satisfied by the reasons given, it's alright. If not to safeguard his interests, he must state this fact in his report. Sometimes, the debt of a debtor is in dispute and the client might have filed a suit for recovery of the same in court of law. Under such circumstance, sending a letter of confirmation, may add to the bitterness between the two parties. Here the management is justified in making such a request to the Auditor.

Evaluation of the response received.

After the Auditor receives confirmation letter from the parties concerned the Auditor should consider the reliability of such responses. Sometimes, such responses received may not be reliable. He should consider the authenticity of the response and follow appropriate procedure to clear his doubts.

When the Auditor is not fully satisfied with the evidence he has collected, he should undertake additional procedures. While taking such a decision, he should consider the reliability of the confirmation and the alternate procedures, implications of the figures both quantitative and qualitative and evidence provided by other procedures. Considering these points, he must decide whether additional audit procedure is necessary.

If he comes across any difference between the information provided by the management and the one collected through letters of confirmation, he should ask the management to reconcile the discrepancies. Explanation give by the management on such points, should also be further verified. He should also consider the causes and frequency of exceptions reported by the respondents. He should look deep in to the causes of misstatements in the financial statements.

The Auditor should thus evaluate the results of the external confirmation process and results from any other procedure followed and decide whether sufficient reliable evidence is collected or not.

Difference between Indian and International Standard:

Normally both do not differ. But sometimes there are certain minor differences between the two. Institute of Chartered Accounts makes certain changes in the International Standards, taking in to account the conditions in India. In this standard also there is some such difference. E.g.

(1) Indian Standard expects the Auditor to take information from earlier year's audit reports also. ISA does not provide for such verification.

(2) In the case of discrepancy found between the figures in the financial statements provided by the management and the information received from third parties, the Indian Standard requires the Auditor to give an opportunity to the management to reconcile the information. ISA does not provide for such requirement etc. *This standard on auditing is effective for a audit related to account period beginning on or after 1.4.2003*.

CHECK YOUR PROGRESS:

(a) Importance of external confirmation
(b) Utility of external confirmation
(c) Drafting of the letter of confirmation
(d) Limitation of the system
(e) Procedure followed for external confirmation

7.5 SUMMARY:

In this chapter, you have studied three standards on auditing namely 500, 501 and 505.

SA 500 deals with the audit evidence in general. Before expressing his opinion the Auditor should collect sufficient and reliable audit evidence. Reliability of the evidence depends upon the source and its nature. The Auditor should evolve a suitable procedure to collect reliable audit evidence. Evidence collected should be appropriate. Written evidence is more reliable than oral evidence and evidence provided by the third party is more reliable than the evidence generated internally.

SA 501 deals with audit evidence for some specific items namely attendance at physical inventory counting, inquires regarding litigation and claims valuation and disclosure of long term investments and segment information. Physical counting of the inventory is primarily the responsibility of the management. In all these four cases the Auditor has to take a written representation from the management that they have taken necessary steps before including the relevant figures in the financial statements.

SA 505 deals with external confirmations. Here letter are sent to third parties and they are requested to confirm the correctness of different figures in the financial statements after verifying their own records. Such evidence is supposed to be more reliable as it is provided by the third party, which has no personal interest in the matter and is given in writing.

In short the Auditor should not sign his report unless he collects sufficient, appropriate and relevant evidence and he is fully satisfied.

7.6 QUESTIONS:

1. What is Audit Evidence?
2. What are the different types of audit evidences?
3. What are the duties of the Auditor under SA 501 in respect of attendance at physical inventory counting?
4. What are the duties of the Auditor under SA 501 in respect of valuation and disclosure of long term investments?
5. Management certificate obtained by the Auditor is enough for verification of inventories. State whether the statement is true or false giving reasons in support of your answer.
6. List the situations where external confirmation can be used.
7. Balance confirmation from Debtors/Creditors can only be obtained for balances standing in their account at the year end. Give your comments.
8. What is meant by external confirmation?
9. What are positive and negative external confirmations? In what circumstances they are used?
10. Say whether the following statements are true or false.
    a. The audit technique of confirmation is a formal inquiry from insiders.
    b. The managements refusal to provide a requested representation also constitutes an audit evidence.

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8

NEW STANDARDS ON AUDITING SA 510, SA 520 AND SA 610.

Unit Structure :

8.0 OBJECTIVES

After studying the unit the students will be understand:

- Various definitions as per AS 510 revised
- Meaning, purpose and definition of analytical procedures as per AS 520

8.1 INTRODUCTION:

In this chapter you will be studying the details of next three standards on audit namely SA 510 on Initial Audit Engagement, SA 520 on analytical procedures and SA 610 on using the work of internal auditor. Let us now consider these standards one by one.

8.2 STANDARD ON AUDIT 510:INTIAL AUDIT ENGAGEMENTS – OPENING BALANCES

This standard is made applicable to all audits conducted on or after 1st April, 2010.

This standard deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement.

Opening balances means the balances which existed in the beginning of the period, these are the same, which were closing balances in the immediately preceding year and brought forward to the current period. Therefore these opening balances carry the effect of the previous periods.

If the same auditor had audited the accounts of the entity last year there is no problem of checking the opening balances because after all opening balances of this year, are the closing balances of the previous year, which have already been verified by him. The question of verifying the opening balances arises only in the case of initial appointments.

Here, there are two possibilities:

(1) The accounts of the entity were so far not audited at all due to its small size or any other reason. Such situation arises only in the case of sole trader or partnership firms doing business on a small scale. In the case of large scale business or in the case of companies, audit of accounts by a chartered accountant is compulsory under law. In their case, such contingency may arise only in the first year of their business.

(2) The accounts of the business were audited last year by the auditor of any other firm and the entity has changed its auditor and the work is allotted to a different auditor.

In either of the above contingencies, it becomes necessary for the auditor to collect sufficient reliable evidence and check the opening balances.

It should be remembered that the correctness of opening balances is very important, because they are the basis on which the financial statements of the current year are prepared. If the very base is wrong, the financial statements of the current year are bound to be also defective.

In addition to financial statement amount, opening balances include matters requiring disclosures that existed at the beginning of the period such as contingencies and commitments.

According to proposed SA 710 financial statements should also include comparative financial information. When it comes in to effect, the opening balances will also include these things, SA 710 is being revised in the light of corresponding international standards on audit. Of course this S.A. is not included in your syllabus.

Objective

In conducting an initial engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether

(a) Opening balances contain any misstatements that materially affect the current periods' financial statements and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements or changes there to are properly accounted for and adequately and suitably presented and disclosed in accordance with the applicable financial reporting frame work.

Definitions

(1) **Initial Audit Engagement**.

Initial Audit Engagement means an engagement in which either financial statements for the prior period were not audited or audited by a predecessor auditor

(2) **Opening balances.**

Opening balance are those account balances that existed at the beginning of the period. They are the closing balances of the previous period. They also include contingencies and commitments.

(3) **Predecessor Auditor**

Predecessor Auditor is an auditor from a different audit firm who audited the financial statements of the client in the prior period and who has been replaced by the current auditor.

The purpose of this standard is to establish standards regarding audit of opening balances in case of initial engagement i.e. when the financial statements are audited for the first time by the particular auditor.

Opening balances are those balances in different accounts which existed at the beginning of the period. The fact that, closing balances here has been properly brought forward to the current period is confirmed. It is also verified that there are no misstatements in the opening balances. That will materially affect the financial statement of the current year and that accounting policies are consistently applied. The auditor should know the accounting policies of the client and study the audit report of the previous year. He should assess the materiality of different opening balances.

Opening balances reflect the effect of transactions and other events of the previous period and accounting policies applied in the preceding period.

Audit Procedure

To begin with the auditor should read last year's financial statements and the auditor's statements and the auditor's report there on, if the accounts of the client were audited by a different auditor last year. To collect information about the opening balances he should collect sufficient evidence to check the opening balances in the current year's financial statements. Last year's closing balances will naturally become the opening balances of this year. He should check whether, last year's all closing balances have been properly carried forward in this year's accounts or not. If there are any changes made in the profit and loss account due to changes in the accounting policies, they should be separately shown.

At this stage, it should be remembered that normally accounting policies once adopted, should not be changed. One example of accounting policy is the method of writing off depreciation. Because, change in the accounting policies, may affect the final results of the concern. There will be changes in the final profit or loss. This will make comparison of the accounts of two years, difficult. So, as and when, the accounting policies are changed, for any reason whatsoever, its effect on the final results of the business should be disclosed in the accounts.

If the auditor finds that there are any misstatements in the prior period financial statements which are likely to affect, this year's financial statements, he should perform additional audit procedures, and determine their exact impact on this year's financial statements. If he finds that, similar misstatements are there in this year's financial statements also he should communicate them to the management and get the statements duly corrected.

In short, the auditor should collect sufficient audit evidence to check whether accounting policies in the opening balances, have been followed in the current year also and if not, their impact should be prominently disclosed.

It should be remembered that the fact that preceding period financial statements were not audited, does not in any way reduce the auditor's need to obtain sufficient evidence regarding opening balances.

If the auditor fails to collect sufficient audit evidence regarding opening balances he may give qualified opinion or add a disclaimer to this effect.

If he comes across any minor defects in the last year's auditor's report and the same can be easily adjusted in the accounts of the current year, he need not qualify his report.

Current Assents and Current Liabilities :

Some evidence can be collected from the books of accounts only for some current assets and liabilities like the opening balance of debtors and creditors. For the opening debtors there will be collection during the year and for opening creditors, there will be payments during the current year. Collections and payments, can provide some evidence of existence of opening debtors and creditors. The auditor can also take a total of opening balances of each account of the debtor and creditor to check the accuracy of the opening debtors and creditors. As regards opening inventory, the closing balance of the inventory in the last year's financial statements may provide some evidence. Some additional procedure will be advisable like observing current inventory count and reconciling it with the opening inventory quantities, considering gross profit, valuation of the opening inventory etc.

There is no difficulty in checking the bank balance and the bank overdraft balance as the pass book and bank balance certificates are readily available.

For non-current assets and liabilities like long term debt accounting records may be examined. He can also obtain confirmation from the concerned parties, in respect of long term debts and investments. Fixed assets register may provide evidence regarding opening balance of fixed assets.

In short, this standard deals with collection of audit evidence for verifying the opening balances in the case of initial engagement.

CHECK YOUR PROGRESS :

(a) What is initial engagement?

(b) What are opening balances?

8.3 AUDIT STANDARD 520 :ANALYTICAL PROCEDURES

This standard is made effective for audits from 1st April, 2010

Meaning, purpose and definition of analytical procedures

The purpose of this standard on auditing is to establish standards on the application of analytical procedures during an audit. The auditor should apply analytical procedures at planning and overall review stage of the audit. They may also be applied at other stages.

SA 500 on audit evidence defines analytical review as tests of details which consist of studying significant ratios and trends and investigating unusual fluctuations and items. Thus analytical reviews are substantive audit procedures.

SA 520 on analytical procedures states that analytical reviews are analysis of significant ratios and trends including resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.

Analytical procedures are particular type of substantive test to judge the overall reasonableness. Analytical procedures include the consideration of comparisons of the entity's financial information with for example comparable information for prior periods, anticipated results of the entity such as budgets or forecasts, predictive estimates prepared by the auditor such estimation of the auditor such as estimation of depreciations charge for the year etc. Entity's ratio of sales to trade debtors may be compared with industry's average or with other entities of the same size in the industry. Gross margin percentages of different year or different units in the industry for the same year may be compared Auditor may use here financial as well as non financial information for calculation of ratios. Example of non financial information is number of employees and space used for sales etc. Pay roll costs may be compared with number of employees or sales may be compared with space occupied for sales etc. and soon.

Different methods may be used here. Sometimes very simple methods may be used but where necessary even advanced statistical techniques may also be employed: such study may be made for the whole unit or its components like different divisions departments etc.

The auditor selects the suitable method based on his past experience. After all this is a professional judgement.

Analytical procedures include the following types of tests : -

1) **Trend analysis :**

   Here financial information of the firm may be compared with the information of the previous years.

2) **Comparative data analysis :**
Entity's financial information may be compared with anticipated results.

3) **Predictive estimate analysis :**
Here the relationships between different figures anticipated by the auditor are studied.

4) **Inter firm analysis :**
Key financial ratios of the entity are compared with other firms of the same size in the industry or with the average of the industry as a whole.

5) **Financial ratio analysis :**
Relationships among different financial information is studied e.g. gross profit turnover ratio etc.

6) **Key financial ratios :**
Relationships among elements of financial and non financial information is studied e.g. payroll costs to number of employees or sales per employee etc.

The purpose of analytical procedures :

The purpose behind making a study of financial procedures by the auditor can be summarised as follows :

1) To assist the auditor in planning the nature, timing and extent of other audit procedures.

2) To serve as substantive procedures when there can be more effective or efficient in reducing risk of financial statement assertions.

3) To provide evidence as to the completeness accuracy and validity of the data produced by the accounting system, based on interrelationships between different financial data.

4) To provide a tool to overall review of financial statements in the final review of an audit.

Now let us consider two examples of use of analytical procedures namely in the case of inventories and debtors and loans and advances.

1) Inventories :
Quantity of opening stocks, purchases, production, sales and stocks may be reconciled. Closing stock quantities may be compared with the closing stock balance of the last year, stock

turnover ratio of the current year may be compared with that of the last year. Gross profit ratios of the two years may also be compared.

2) Debtors, loans and advances :

Closing balances of debtors, loans and advances may be compared with the figures of the last year. Industry's standards can also be considered, if the same are readily available. Actual figures may be compared with the budgeted figures if the budgets are prepared. Ageing schedule (outstanding periods) of the current year may be compared with the corresponding figures of the previous year.

Thus the above two examples will clarify how the method is used in practice.

In some cases, documented information, useful for analysis may not be available. In such cases, the auditor may obtain the required information through discussion with the owner or manager of the business entity.

Analytical procedures are often cost effective means of obtaining audit evidence. The auditor studies the controls over the collection of information prevalent in the unit. When such controls are found to be satisfactory, the auditor will have more confidence in the reliability of the information. Here the results of the analytical procedures used will be naturally more reliable.

Analytical procedures may not be of much use in case of small entities as the necessary reliable data for the purpose, may not be available.

Following ratios are generally used in analytical procedures.

Turnover : Gross Profit Ratio
Debtor Turnover Ratio
Stock Turnover Ratio etc.

Trends used
Comparison to industry
Comparison to economy
Capacity utilisation
Warehouse capacity etc.

Finance and non finance relationships, salary expenses to number of employees. Sales to quantity sold sales figure to capacity utilised. Comparison of budgeted figures with actual figures etc.

Analytical procedures can be used by the auditor at the following stages of audit procedures.

(i) Planning the Audit or preparing an audit plan.
(ii) As substantive procedure.
(iii) In the overall review at the end.
(iv) Investigating unusual items.

Let us now consider the above points in further details.

I) Preparing an Audit Plan :

The Auditors can use analytical procedures at the planning stage to understand thoroughly the nature of the business and in identifying areas of potential risk. Application of analytical procedures may indicate aspects of the business of which the auditor was unaware and will assist in determining the nature, timing and extent of other audit procedures.

Analytical procedures at this stage may use both, financial and no financial information. E.g. the relationship between sales and square footage of selling space or volume of goods sold. The purpose of analytical procedures is to assist the auditor in planning the nature, timing and extent of other audit procedures.

By applying analytical procedures at planning stage an auditor can identify the area of potential risk, e.g. If there is wide variation in gross profit ratio compared with previous year the auditor may check sales and closing stock in greater details.

II) Analytical procedures as substantive procedure :

The auditor will rely on the analytical procedure to reduce detection risk. The decision about which procedure to use will be decided by the auditor on the basis of his audit objective. This is a matter of professional judgement which is based on his knowledge and previous experience.

He will discuss the reliability of the information with the management. If the data is prepared by the expert staff of the client, the auditor would use this method. He should be personally satisfied about the ability of the staff to prepare reliable data.

Before taking such as decision, the auditor will consider the following factors :

1) Objective of the analytical procedures.

2) The nature of the entity.

3) Analytical procedure may be more effective when applied to different sections or departments separately.

4) Whether the budgets are prepared with sufficient care?

5) Information used is reliable.

6) Source of information is reliable. Information collected by independent source is more reliable than the one collected internally by the client.

7) Knowledge gained during previous audits. Such knowledge will help the auditor to decide about the effectiveness of this method in this case.

III) Analytical procedures in the overall review at the end of the Audit :

The Auditor should apply analytical procedure at or near the end of the audit before finalising overall conclusions. The auditor will take his final decision about the financial statements only after following analytical procedures. The conclusions drawn from the results of such procedures are intended to corroborate the opinion formed by the Auditor earlier about the financial statements. In some cases such a study may identify areas where further procedures need to be applied.

The application of analytical procedures is based on the expectation that the relationships among data exists and it will continue. The data provided by the accounting system is checked by such analytical procedures.

In making use of this system, the auditor will take in to account the materiality of the items involved. The auditor will mainly use this system for certain income and expenditure items.

IV) Investigating unusual items :

When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.

The investigation of unusual fluctuations and relationships, ordinarily begins with the inquiries of management followed by :

a) Corroboration of management's responses with the knowledge of the business of the auditor.

b) Need of applying other audit procedure is also considered if the management is unable to provide adequate satisfactory explanation.

Thus when significant variations are noticed, the auditor should go in for detailed investigations.

Reliance

Reliance on analytical procedures depend upon the following factors :

1) Materiality of the items involved :

a) When inventory balances are material, analytical reviews alone will not be sufficient in forming the audit conclusions.
b) Where some individual items of income or expenditure are not material, comparisons with previous year's data may provide sufficient audit evidence.

2) Other Audit Procedures.
When other audit procedures are used in the same area, analytical reviews may provide confirmatory evidence.

3) Accuracy of predictions :
If the expected results of analytical procedures can be predicted with reasonable accuracy, such procedures will be more reliable. E.g. percentage of gross profit over various periods would be consistent and gives more audit evidence than research and development expenditure or advertising expenditure etc.

4) Nature of risks :
The effect of analytical procedures also depends upon the assessment of the inherent and control risks. E.g. If internal control on sales order processing is weak, and hence control risk is higher, more reliance will have to be placed on tests of details of transactions and balances.

5) Efficient control :
The Auditor will need to consider testing the controls if any over the preparation of information used in applying analytical procedures. When such controls are effective auditor will have greater confidence in the reliability of the information and in the results of analytical procedures.

The control over non-financial information should be tested along with tests of accounting related control.

Check your progress :

a) What are analytical procedures?
b) When are they used?
c) How far they are reliable?

8.4 SA 610 (REVISED): USING THE WORK OF INTERNAL AUDITORS

This standard on auditing is applicable to all audits conducted on or after 1st April 2016.

This standard deals with external auditor's responsibility regarding the work of internal auditor. External auditor is also called statutory auditor as he is appointed according to the provisions of different Acts such as Indian companies Act. Indian trusts act etc. It is applicable when the external auditor decides that the function of the internal auditor is relevant to his audit work. The purpose of this standard is to provide guidance as to the procedures which should be applied by the external auditor to assess the work of the internal auditor. This will help him to decide whether and to what extent he should rely on the work of the internal auditor.

What is Internal Audit?

Internal audit is a separate part of internal control system. The objective of the internal audit is to determine whether other internal control systems are well designed and are being properly operated. He is appointed by the management of the client and is part of an overall organisation system of internal control. The management which makes his appointment also prescribes the scope of his work.

That way appointment of internal auditor is not compulsory under the law. Still all big business units appoint an internal auditor because his appointment is beneficial to the unit. It helps the organisation to detect and prevent errors and frauds at on early date.

In some organisations, there is a separate internal audit department. Some concerns appoint an outsider as an internal auditor.

The scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity and the requirements of the management.

Internal audit is an independent management function which involves a continuous and critical appraisal of the functioning of the entity. Internal auditor suggests improvements and adds value and strengthens the overall governance mechanism of the entity and internal control system. Internal audit therefore provides assurance that there is transparency in reporting as a part of good governance.

Internal auditor performs the activities of the internal audit function.

Revised SA 610 provides that the internal auditor should not show his working papers to third party.

The nature of the responsibilities and his status in the organisation vary widely. It depends upon the size and structure of the entity and the requirements of the management.

Objectives of internal audit.

Normally the following are the objectives of internal audit.

1) Review of accounting system and internal control.
2) Examination of financial and operating system.
3) Examination of effectiveness and efficiency of financial control.
4) Physical examination and verification.

The establishment of an adequate accounting system and related control is always the responsibility of the management. It demands, proper attention on a continuous basis. The internal audit function is often assigned specific responsibility by management for reviewing the accounting system and related controls. Internal auditor has to suggest improvement in this system as and when necessary. Internal auditor, verifies the physical existence and condition of the different tangible assets of the entity.

Objectives of an external auditor are :

The external auditor expects to use the work of the internal auditor to provide direct assistance. He may also determine whether direct assistance from internal auditors can be used, and if so, in which areas and to what extent. If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

Importance of Internal Audit

Internal Audit plays very vital role in internal functioning of any large business entity. Internal Audit is an independent and objective assurance to improve the operations of the organization. Internal audit plays an important role in evaluating operations of business which in turn helps to reduce risks, improving internal control, enhance the effectiveness of various processes of organisation. Usually the internal auditors have complete and detailed access to information, records and personnel of the company. Internal Audit is also useful in providing assurance relating to corporate governance.

Difference between internal and external auditor.

They differ on the following grounds

Internal Auditor	External Auditor
Appointment	
1) Management appoints the internal auditor	Shareholders appoint external auditor
Objectives	
2) To ensure already laid down policies procedures and other internal control system is functioning as desired	Express opinion on the financial statements as to whether, these statements are showing true and fair view of the financial position of the concern.
Scope	
3) The management prescribes the scope of audit.	Concerned law prescribes the scope.
Independence	
4) Comparatively less independence as he is the part of the organisation	More independent in reporting as he is an outsider
Format of Report	
No format is prescribed. It depends on the nature of the work, coverage and observations	Aspects to be covered in the report are specifically prescribed by law and I.C.A.I. recommendations

Through there are above major differences, the method of work of internal and external auditor are similar in many respects. So the work of the internal auditor is useful to the external auditor. E.g. internal auditors work is useful to the external Auditor in determining the nature, timing and extent of his procedures. So, the external auditor should, as part of his work, evaluate the internal audit function. He should verify, to what extent he has followed substantive procedures prescribed by the management.

Internal control system means all the policies and procedures adopted by the management to assist in achieving the objectives of the management. Internal audit as we have seen earlier, is the part of the internal control system. Assets of the business should be safeguarded. Frauds and errors should be prevented. Accounting records should be accurate and complete. Correct financial statements should be prepared in time. External auditor will assist the internal auditor and guide him in his work from time to time.

Can external auditor rely on the work of internal auditor?

The answer is yes but to a limited extent. External auditor has the sole responsibility of his report. However much of the work of the internal auditor may be useful to him in his examination of financial statements. External auditor has to decide, whether and to what extent to use the work of the internal auditor and whether such work is adequate for his purpose. When the external auditor uses the specific work of the internal auditor, he shall document his conclusions regarding the evaluation of the adequacy of the work of the internal auditor and the audit procedures performed by him on that work.

Using the work of internal auditor

It should be remembered that through the external auditor can use the work of the internal auditor, his responsibility of his report is in no way reduced. So, he must evaluate the work of the internal auditor and then decide as to what extent he can rely on the same. While taking this decision, he must take in to account the following factors : -

1) Whether internal audit is undertaken by an outside agency or by a department within the organisation? Work of the outside agency will be more reliable than the work of the internal department.

2) Scope of the internal audit and to what extent the management implements the suggestions made by the internal auditor.

3) What are the qualifications of the internal auditor and how much experience he has on this job?

4) Whether internal auditor takes due professional care and whether his work is properly planned, supervised and documented? There should be an audit manual to guide him in his work.

Internal auditor should have proper status in the organisation and he should be free to express his opinion frankly. He should enjoy as much independence as possible and should not be burdened with other responsibilities in the organisation.

External auditor should also test the work of the internal auditor on which he intends to rely. Such test may include sample checking of some of the items, already checked by the internal auditor. etc.

Co-ordination

There should be proper co-ordination between internal and external auditors. They should meet from time to time and discuss their common problems.

In short the purpose of this standard is to provide guidance as to the procedures which should be applied by the external auditor in assessing the work of the internal auditor for the purpose of placing reliance on his work. However, the sole responsibility of his report always rests on the external auditor only.

Check your progress :

a) What is internal audit?
b) Difference between the work of internal and external auditor.
c) Can external auditor rely on the work of the internal auditor?

8.5 SUMMARY

You have studied last three standards, from your syllabus viz SA 510, SA 520 and SA 610 (Revised) in this chapter.

SA 510 :

Initial audit engagements - opening balances. Initial audit engagement may be either the appointment of the auditor by the client for the first time or it may be due to change in the appointment of the auditor. In either case the newly appointed auditor has to verify opening balances in the financial statements. Opening balances of the current year are the closing balances of the last year. Verification is important because this year's closing balances will depend upon the opening balances brought forward from last year. The auditor has to collect sufficient reliable evidence to verify the correctness of these opening balances. The purpose of this standard is to establish standards regarding the audit of opening balances. Opening balances reflect the effect of last year's transactions. So to begin with the auditor should go through the last year's financial statements and auditor's report. He should confirm that the accounting policies are not changed during the year. If they have been changed, their impact should be separately shown.

Current assets and liabilities are verified from the books of accounts and also by sending letters to the concerned parties for the confirmation of their balances. Selection of persons to whom such letters are to be sent is to be made by the auditor and their response should be received directly by the auditor only. As far as non current assets and long term liabilities, records may be examined and wherever necessary, confirmatory letters may be sent.

SA 520

Analytical procedure :

The purpose of this standard is to establish standards on the application of analytical procedures during an audit. This method can be used at 4 different audit stages viz. planning stage, as substantive procedure, overall review and investigating unusual items. Analytical procedures include calculation of different ratios and making trend analysis.

SA 610 (Revised)

Using the work of internal auditors.

This standard deals with the responsibility of the external auditor while using the work of internal auditors. The purpose or objective of internal and external audit is different. But the procedure followed by both is almost similar. So, much of the work of the internal auditor is useful to the external auditor. However it should be distinctly remembered that the sole responsibility of the report is on the external auditor only. Thus using the work of the internal auditor may reduce his physical labour but not his responsibility. So, the external auditor should make a through study of the internal auditor's work, his independence or status in the organisation, his educational qualifications and experience in the field and then decide to select the work of the internal auditor on which he can rely.

8.6 QUESTIONS

A. Descriptive Questions

1) Write a short note on initial engagement,
2) What do you mean by initial engagements and opening balances under SA 510?
3) What are the auditor's duties in respect of opening balances?
4) Analytical procedures are efficient and cost effective means of auditing a small entity. Comment.
5) State the different types of analytical reviews carried out in the verification of (i) inventories and (ii) debtors, loans and advances?
6) What is internal audit?
7) Explain the relationship between the statutory and internal auditor.
8) State whether the following statements are true or false.

a) The auditor may apply analytical procedures at the planning and overall review stages of the audit.
b) Internal audit report is the property of the internal auditor and the statutory auditor has no right to inspect the same.
c) The old auditor must hand over his working papers to the new auditor appointed in his place.

9) Can the statutory auditor rely on the work of internal auditor? Discuss.

B. State whether the following statements are 'True' or 'False':

1. Auditor can directly start working without any planning of the audit.
2. When the auditor delegates his work to subordinate, the responsibility of the work also passes on the subordinate.
3. During the course of Audit, the auditor shall not disclose the confidential matters to any competitors or clients.
4. Auditor need not keep himself updated with audit procedures, as the Auditing Standards are not updated every year.
5. Auditor shall obtain reasonable assurance whether there financial statements are free from material misconduct.
6. The Auditor shall meticulously follow Audit Plan unless there is an emergency to change it.
7. Auditor can totally rely on any kind of audit evidence without further inquiry.

8. Auditor's report should be based on evidence obtained by him during the audit.
9. Auditor need not check the policies followed by the company, as auditing standards are mandatory, so it is assumed that the company has followed them duly.
10. If Auditor wants to qualify the audit report, he can do so with proper reasons.
11. Auditor has to be convinced that the books represent true and fair view.
12. If the management does not prepare financial statements, Auditor shall first prepare it and then perform the audit.
13. The management can decide what material is and what is not, on the basis of their professional experience and judgment.
14. Auditor should be financial as well as technical expert.
15. Auditor must compare the data in the books of accounts with the available evidence.
16. The Auditor can make conclusions on matters which are not audited by him but are for same client and the auditor is well aware of the business of the client.
17. Auditor can make necessary changes if he thinks there are defects in the internal control system.
18. The Auditors opinion is only on the financial statements.
19. Financial statements are prepared by the management.
20. If the audit is performed, it means there is no fraud or error in financial statement.
21. SA 210 deals with the auditor's responsibility in agreeing the terms of audit engagement with management
22. SA 210 is effective for audits of financial statements for periods beginning on or after April 1, 2010
23. Auditor can perform same procedures on different type of organizations.
24. As the management prepares financial statements, auditor need not obtain any agreement for the same.
25. Auditor to be provided with unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.
26. In case of recurring audits, auditor is not required to assess whether the circumstances require the terms of audit engagement to be revised.
27. The auditor along with the management will record the existing terms of an audit engagement.

28. If auditor is unable to agree to a change in terms of audit engagement and is not permitted by law to continue with original engagement, the auditor should still continue the audit and qualify the audit report.
29. Auditor can guarantee 100% correctness of the accounts or absence of any frauds.
30. Audit procedure should be so organized as to cover all aspects of the enterprise and all statutory requirements are complied with.
31. SA 220deals with maintaining Quantity in the audit work.
32. The Auditor has the final responsibility for the Audit.
33. SA 220 is effective for audits of financial statements even before April 1, 2010.
34. The auditor does not need to implement quality control measures.
35. Auditor should be an independent person and should not have any vested interest in the client.
36. When an audit assistant commits any mistake, the responsibility is on the assistant as he has performed the work.
37. The auditor can discuss the audit work with outsiders who are expert in the respective field.
38. While securing new work, auditor should not adopt unfair practice.
39. As auditor's target is to prepare the audit report on time, he may ignore quality of the audit procedures performed.
40. Overall Audit plan should be explained to audit assistant and importance of his job in the overall plan should also be explained to him.
41. Work performed by audit assistant can be reviewed at the end of the audit program.
42. The auditor should personally review the work done by audit partner, go through the relevant work papers and then sign the report and other documents only if he is personally satisfied.
43. The auditor should maintain audit evidence to show that the audit was performed in accordance with the set procedure prescribed by different SAs.
44. Audit documentation means the record of the audit procedures performed, evidences obtained and the conclusions drawn by the auditor.
45. If the auditor discusses certain matters with some outside experts, he does not need to keep the record of such discussion.

46.Auditor should make documentation of all important professional judgements he has made during the course of the audit.

47.All audit papers should be carefully retained at least for a period of not less than eight years after the completion of audit report.

48.The normal practice is that the auditor keeps these papers with the client, as the papers are related to that particular client.

49.The working papers are just a rough working and not report hence it need not be sufficiently complete and detailed.

50.Working papers are so important that an auditor takes help from his working papers in preparing his final report.

51.A transaction is not recorded wholly or partially is called Error of Commission.

52.In compensating errors, trial balance will agree.

53.Errors are unintentional and frauds are intentional and sown deep.

54.It is Auditor's responsibility and he is expected to decide whether a legal fraud has been committed or not.

55.Auditor cannot say that audited accounts are free from any errors or frauds and that they are hundred percent correct.

56.Primarily it is the duty of the management to take all necessary steps to prevent frauds.

57.If the response of the management is not reasonable on finding fraud by the auditor, the auditor should resign immediately from the assignment.

58.Planning an audit of financial statement is governed by SA 240.

59.The audit plan prepared should be rigid or unchangeable.

60.The nature and extent of planning will depend upon the size and complexity of the business of the client.

61.In the case of larger concerns, a detailed plan may have to be prepared.

62. The purpose of collecting audit evidence as per SA 500, is to verify to what extent the assertions made by the auditor are valid

63.It is not obligatory on the part of the Auditor, to collect sufficient reliable evidence, before forming his opinion on the correctness of the financial statements.

64.The auditor cannot take external confirmations from creditors or debtors.

65.Auditor should insist upon verification of the evidence by an outside expert so that the opinion given is unbiased.

66.Internal evidence may not be as reliable as external evidence.

67.If the stock is located at various places, then the auditor should attend all the places for stock audit.

68.Physical verification of inventory is primarily the responsibility of the management.

69.Written confirmation from the third party is always more reliable evidence as they are not related to the unit.

70.If the management refuses the auditor for external confirmations, the auditor should not make further inquiry.

Solution :

[True :

3, 5, 6, 8, 10.11,15,17,18,19, 21, 22, 25, 27, 30, 32, 35, 37, 38, 40.42, 43, 44, 46, 50, 52, 53,55, 56, 57, 60, 61,65,66, 68,69.

False :

1, 2, 4, 7,9, 12,13,14,16,20, 23, 24, 26, 28, 29, 31, 33, 34, 36, 39, 41,45, 47, 48, 49, 51,54, 58, 59, 62, 63, 64, 67,70]

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9

SPECIAL CONSIDERATION IN AUDIT I GOVERNMENT AUDIT

Unit Structure

9.1 INTRODUCTION

Every audit has its own unique features, requiring special skills, Knowledge, related Statutory Provisions / Requirements, peculiar accounting methods used etc. There are certain common features with all types of audits. Auditors should include following points in addition to usual / special requirements [these are common points for most of Special points]

i) Audit Programme should be specially designed for such entities, considering Accounting system, Internal controls and it's effectiveness, compliance of Legal Requirements, etc.

ii) The main Substantive procedures to be followed in any other audit are also required to be followed in any special audit, which are as under :

a) Obtain Appointment letter indicating nature of work & its scope

b) Determine overall audit objectives, True & Fair View, Legal Requirements

c) Names of Executives, Accountants, Trustees, as the case may be etc. their specimen signatures and their powers

d) Past Audit Reports, internal audit reports in any.

e) Communication with previous auditor, in case of new appointment

f) Past Financial statements.

After considering above, effectiveness of Inter Control, Auditor can decide test checks on the following:

Opening balances, Vouching, Posting, Casting, Ledger Scrutiny, Verifications of various Assets & Liabilities on date of year end, Purchase and Sale of Fixed Assets. Fixed Assets Register, Trial Balance or Receipts & Payments a/c, Final Accounts and its Approval by appropriate Authorities.

However, it must be noted that the varying transactions of every different entity have their special features which have to be considered by the Auditor in drawing Audit programme.

9.2 GOVERNMENT AUDIT INTRODUCTION

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 executive of the spending agencies to the sanctioning or controlling authorities. 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 there under.

9.3 LEGAL FRAMEWORK AND COMPTROLLER & AUDITOR GENERAL

The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C & AG. 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 misbehavior or incapacity. 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.

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 Services) Act, 1971 defined these functions and powers in detail.

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 prescribed.

Article 151 requires that the reports of the C & AG relating to the accounts of the Union / State shall be submitted to the President / Governor who shall cause them to be laid before House of Parliament / State Legislature.

Duties of 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 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 Provision Relating to Audit – It shall be the duty of the Comptroller and Auditor General –

a) To audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it.

b) To audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts.

c) To audit and report on all trading, manufacturing 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.

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 rupees twenty-five lakhs and the amount of such grant or loan is not less than seventy-five per cent 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 Stock – The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and stock 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, 1956.

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 it is his duty to prepare.

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.

9.4 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 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 authorizing 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 authorized 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 or 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 there under. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. 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, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by Government servants in dealing with government transactions; and
iii) Rules and orders regulating the conditions of services, 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.

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.

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 purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made there under, 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 in fructuous 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. A building may be constructed for installing a telephone exchange but may not be used for the same purpose resulting in in fructuous expenditure or a school building may be constructed but used after five years of its completion 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 recognized as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

1. 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.
2. No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
3. 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 recognized policy or custom; and

iv) The amount of allowances, such as traveling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

It may be stated that it is the responsibility of the executive departments to enforce economy in public expenditure. The function of audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper, avoidable and infructuous expenditure.

5. Performance audit – The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit. Efficiency audit look into whether the various schemes / projects are executed and their operations conducted economically and whether they are yielding the results expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner. Economy audit looks into whether Government have acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy. Effectiveness audit is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness. The procedure for conducting performance audit covers identification of topic, preliminary study, planning and execution of audit, and reporting. While the trend towards a comprehensive approach for conducting performance of full scope audit is visible, the coverage and depth of evaluation vary according to the statutory limitations, and the organisational constraints of C & AG.

9.5 AUDIT OF RECEIPTS

The audit of receipts is neither all pervasive nor 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, realized and credit 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.

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 organizational and institutional arrangements obtaining.

9.6 AUDIT OF COMMERCIAL ACCOUNTS

Public enterprises are required to maintain commercial accounts and are generally classified under three categories:

a) Departmental enterprises engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other Government departments and agencies;

b) Statutory bodies, corporations; created by specific statutes mostly financed by Government in the form of loans, grants, etc. and

c) Government companies set up under the Companies Act, 2013.

i) Appointment of Auditor

In accordance with the provisions of Section 139 of the Companies Act, 2013 (earlier section 619 of the Companies Act, 1956), in the case of a Government company, the Comptroller and Auditor-General of India (C&AG of India) shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies, within 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

ii) First Auditor appointment

The first auditor of a Government company shall be appointed by the C&AG of India within 60 days from the date of registration of the company; in case C&AG of India does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next 30days; and in case of failure of the Board to appoint such auditor within the next 30 days, Board shall inform the members of the company who shall appoint such auditor within the 60 days at an extraordinary general meeting(EGM), who shall hold office till the conclusion of the first annual general meeting.

iii) Casual Vacancy

Any casual vacancy in the office of an auditor of a Government company shall be filled by C&AG of India within 30 days. In case the C&AG of India does not fill the vacancy within the said period, the Board of Directors shall fill the vacancy within next 30 days.

iv) Submission of Audit Report to the C&AG [Section 143 (5)]

The auditor aforesaid 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.

v) Power of the C&AG

The C&AG of India, within 60 days from the date of receipt of the audit report as mentioned above, shall have a right to,—

(a) Conduct a Supplementary Audit:

Conduct a supplementary audit of the financial statement of the company by such person or persons 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 of India may direct; and

(b) Comment Upon or Supplement Such Audit Report:

Provided that any comments given by the C&AG 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 section 136(1) 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.

(c) Test Audit by C&AG of India

The C&AG of India may, if he considers necessary, by an order, cause test audit of a Government company 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.

(d) 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.

(e) The audit of departmental concerns is undertaken in the same manner as any department of Government where commercial accounts are kept. Audit of 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 have 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.

9.7 REPORTING PROCEDURES

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 publicized 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. The overall Indian position regarding reporting standards contained in instructions issued by the C & AG on the subject. Experience and professional judgment ultimately determines what is to be included in the audit reports. The auditor has to be a through professional and the audit reports have to be prepared with great skill for both the presentation and contents should compel readership.

9.8 QUESTIONS

A. Short Notes

1. Propriety Audit
2. Performance Audit
3. Audit of Sanctions
4. Audit of receipt and expenditure
5. Legal framework of CA&G

B. Theory Questions

1. Duties of Comptroller and Auditor General of India
2. Explain Expenditure Audit
3. Explain Audit of Receipts
4. Explain Audit of Commercial accounts by CA&G
5. Explain the role of CA&G in auditing government accounts

C. State whether the following statements are 'True' or 'False':

1. The authority of CA&G to audit the government is derived from the Constitution.

2. Audit report of Union Government prepared by CA&G is placed before the parliament.

3. Audit report of Maharashtra Government will be placed before Rajya Sabha.

4. Finance Accounts of the Government show receipts and disbursements.

5. The function of Government audit is discharged by central bureau of investigation.

6. Article 169 discusses the duties and powers of CA&G.

7. Format of the accounts of the government is decided by Finance Minister.

8. Audit of grants is the audit of assets of the government.

9. Under audit of sactions, it is ensured that expenditure is properly covered by a sanction of authorities.

10. Performance Audit examines whether the expenditure is incurred effectively.

11. The first auditor of a government company shall be appointed by the CA&G.

12. The first auditor of a government company shall be appointed within 90 days of registration of a company.

13. Casual vacancy is a government company is to be filled by the Board of Directors only.

14. Auditors of Government companies are appointed by the President of India.

15. The appointment of CA&G is made under section 139 of the Companies Act, 2013.

16. CA&G is empowered to audit any expenditure from Consolidated Funds of India.

17. CA& G is not empowered to audit transactions relating to the Contingency Fund of the Union Government.

18. CA& G is empowered to audit transactions relating to Contingency Fund of a state government.

[True: 1, 2, 4, 9, 10, 11, 16, 18. False: 3, 5, 6, 7, 8, 12, 13, 14, 15, 17]

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10

SPECIAL CONSIDERATION IN AUDIT II

Unit Structure

10.1 AUDIT OF SOLE TRADER

Most businesses start out as sole trades. This is when an individual starts to trade with a view to making a profit in his own name. It is also associated with the term "self employed".

A sole trader may be just one individual providing services or the individual may have any number of employees working for him. For many reasons a business may be structured as a sole trade. It may depend on the age or size of the business or a professional service provider may be required to operate as a non-limited liability entity. Tax efficiency reasons can often play a role as well.

Sole trader accounts will be required for tax purposes as well as being used for decision making and management purposes. Accounts will also be needed for dealings with external bodies such as banks, Government grant providers, etc.

The sole proprietor owns the business individually, it is managed by him. He may have some paid staffs / workers to assist him. He provides necessary capital to run the business. He may borrow funds required for the business from banks, financial institutions etc. A sole trader operates with unlimited liability. There is no statutory requirement for getting his accounts audited; however, sole traders audited accounts will be required for tax purposes, for securing loans from banks and financial institutions as well as being used for decision making and management purposes.

Account will also be needed to be Audited for dealings with external bodies such as Banks, Government, Grant providers, etc.

A Sole Trader may get his accounts Audited for following reasons:

1. Taxation Purposes (Income Tax, VAT, Services Tax etc.)
2. Borrowing from Banks etc.
3. More dependence on Employees (moral check on employees)
4. Business carried on at number of places
5. For valuation of Goodwill (in case of change in constitution)

Auditor should get appointment letter indicating scope of Audit work. Audit Programme should be prepared specially designed for such Sole Trader, considering Accounting system, Internal controls and purpose for which audit to be carried on.

Auditor should insist that books of accounts are to be maintained on Double Entry principles in case accounts are maintained on single entry, Auditor should qualify his report that books are maintained on single entry and its limitations to Sole Trader.

In case Sole Trader decides audit work for particular purpose then he should get in writing.

Auditor, depending up-on scope & nature of business, should consider following :

a) Vouching of Cash / Bank transactions
b) Vouching of Sales & Purchases
c) Casting & Posting from original entry books to Ledger
d) Verification of various Assets & Liabilities
e) Trial Balance
f) Verify Cut-off procedure, whether properly followed
g) Final Account tally with Books of Accounts

Auditor should express his opinion in Audit Report that is to be submitted to sole trader.

i) The financial statements are prepared using the generally accepted accounting principles which have been consistently applied.
ii) There is adequate disclosure of all material matters and proper presentation of financial information.

10.2 AUDIT OF A PARTNERSHIP FIRM

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.

The Indian Partnership Act, 1932 does not prescribe audit of a partnership firm. Nevertheless, for the verification of adjustment I the accounts of partners made in respect of profits and losses, interest and remuneration of partners, their contribution to capital, etc. It is necessary that the auditor should have a knowledge of the provisions in this regard under the Act – especially that of powers and audit of partners and their right to profit and capital under different situations and circumstances. The auditor may, particularly, ensure application of accounting standards prescribed by the institute. 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. 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., creating 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.

In the absence of a partnership agreement, the provisions of the Act which concern the auditor are the following :

i) Each partner is required to contribute an equal amount of capital.

ii) The partners share equally in profits and losses.

iii) The partners are not entitled to any interest on capital.

iv) Where a partner is entitled to interest on the capital subscribed by him, such interest will be payable only out of profits.

v) A partner is entitled to interest at 6 percent per annum on his advances and loans over and above the capital.

vi) Every partner can take part in the management of the business. A partner is, however, not entitled to receive any remuneration for taking part in the conduct of the business.

vii) Every partner has the right to inspect and to take a copy of any of the books of the firm.

viii) A partner is entitled to be indemnified for all payments made and liabilities incurred by him in the ordinary course of business or in the preservation of the firm's property.

ix) The property of the firm must be held and used by the partners exclusively for the purpose of business.

x) If a partner derives any profit for himself from any transaction of the firm or from the use of the property or business connections of the firm or the firm name, he must account for that profit and pay it to the firm; also the profit from any competing business carried on by a partner without other partners' consent must also be accounted for and paid to the firm.

xi) In the absence of any usage or custom of trade to the contrary, the implied authority of partner does not empower him to :

a) Submit a dispute relating to the business of the firm to arbitration;

b) Open a bank account on behalf of the firm in his own name;

c) Compromise or relinquish any claim or portion of a claim by the firm;

d) Withdraw a suit or proceeding filed on behalf of the firm;

e) Admit any liability in a suit or proceeding against the firm;

f) Acquire immovable property on behalf of the firm;

g) Transfer immovable property belonging to the firm; or

h) Enter into partnership on behalf of the firm.

xii) The firm is liable to third parties :

a) If a partner, acting within the scope of his apparent authority, receives money and misapplies it, or

b) If the firm in the ordinary course of the business receives money, which is misapplied by a partner.

xiii) No person can be introduced as a partner without the consent of the other partners.

xiv) Any differences arising as to ordinary matters connected with the business are to be decided by the majority of the partners, but no change can be made in the nature of the business without the consent of all the partners.

xv) If, on the death or retirement of a partner, no final settlement has been effected and the business is carried on by the surviving or continuing partners, the outgoing partner or his estate has the option of claiming :

a) Such share of prohts as may be attributable to his share of assets or

b) Interest at 6% p.a. on this share of partnerships assets.

xvi) On dissolution of the partnership, every partner has the right to have the goodwill of the business sold for the common benefit of all the partners.

xvii) On a dissolution of the firm, the losses, including deficiencies of capital must be made good :

a) First out of profits;

b) Next out of capital; and

c) Lastly, by the partners individually in the proportion in which they share profits.

xviii) On the dissolution of the firm , assets are to be applied in the following order :

a) In paying the firm's liabilities to third parties;

b) In repaying partner's advances and loans;

c) In repaying partner's capital; and

d) The residue if any, is to be divided amongst the partners in the proportion in which they share profits.

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) **Mitigation of 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) **Actsas an Evidence:** 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) **Computing assessable income:** The accounts of a partnership, which have been audited, are generally accepted by the Income Tax Department as the basis for computing the assessable income of the partners and also for the settlement of their liability in respect of Wealth Tax.

4) **Sanctioning of loans:** 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.

5) **Admission of a partner:** 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.

6) **Protection to working partners:** 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) **Nature and Scope of audit:** Confirming that the letter of appointment, signed by a partner, duly authorized, 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) **Details of Minutes:** Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorization 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) **Partnership agreement:** Verifying that the business in which the partnership is engaged is authorized by the partnership agreement; or by any extension or modification thereof agreed to subsequently.

iv) **Checking Books of Accounts:** 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) **Assessing Interest of partner**: Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorized to do under the partnership deed or by any violation of a provision in the partnership agreements.

vi) **Provision related to taxes payable:** 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 Profit and loss:** 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 Profit and Loss Account 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 a 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 authorized to do or violation of any provision of the partnership agreement.

10.3 REPORTS ON ACCOUNTS OF SOLE TRADERS AND PARTNERSHIP

There is no statutory form of auditor's report in the case of sole traders and partnerships. Often the auditors of sole traders and firms have nothing to say on the audited accounts except "Audited and found correct" or "Examined and found correct". This form of reporting is not recommended as it gives no indication of the extent of the examination of accounts that has been carried out.

The Guidance Note on Members Duties regarding Engagements involving Compilation of Financial Statements to provide guidance on the professional responsibilities of the members of the Institute of Chartered Accountants of India, when an engagement to compile financial statements or other financial information is undertaken and the form and content of the report issued in connection with such a compilation so that the association of the name of the member with the financial statements is not misconstrued by a user of the statements as the same having been audited by him.

For the member, the objective of a compilation engagement is to use accounting expertise, as opposed to auditing expertise, to collect, classify and summaries financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without the requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the member to express any opinion on the financial information. However, users of the compiled financial information derive some benefit as a result of the member's involvement because the service has been performed with professional competence and due care.

A compilation engagement would ordinarily include the preparation of financial statements (which may or may not be a complete set of financial statements) but may also include the collection, classification and summarization of other financial information. Engagements to provide limited assistance to a client in the preparation of financial statements (for example, on the selection of an appropriate accounting policy) do not constitute an engagement to compile financial information.

It is essential that the member clearly brings out the nature of association with the financial statements and the nature of the work performed by him. The following recommendations are made in this regard.

i) The title of the report should be "ACCOUNTANT'S REPORT ON UNAUDITED FINANCIAL STATEMENTS" AND NOT AN 'AUDITOR'S REPORT"

ii) The report should be addressed to the appointing authority.

iii) The report should identify the financial information compiled, also stating that it is based on the information provided by the management.

iv) The report should clearly state that the financial statements are not audited.

v) In describing the engagement, ambiguous terms such as 'review', 'general review', 'check' etc., should not be used.

vi) Date of the report should be mentioned.

vii) Name and address of the firm of the member appointed for carrying out the compilation engagement should be mentioned.

viii) Signatures and the designation (sole proprietor / partner) and membership number should appear in the report.

An example of the report is given below :

Example of an Accountant's Report on Unaudited Financial Statements

To ….

On the basis of information provided by management we have compiled the balance sheet of …. (name of the entity) as of March 31, XXXX and the statement of profit and loss for the period then ended. The balance sheet and the statement of profit and loss are in agreement with the books of account. We have not audited or reviewed these financial statements and accordingly express no opinion thereon.

Date :

For A & Co.
Signature (Name of the partner and membership number)
Partner
Chartered Accountants

10.4 AUDIT OF SMALL COMPANIES

The duties and responsibilities of the auditors in respect of the individual small company client are the same as in larger audits and the satisfactory accomplishment of the work requires the skilful adaptation and application of the principles of auditing to the individual case. Because the relationship with the directors is frequently less formal, it is particularly important that the arrangement and scope of the work should be clearly defined and recorded. A number of problems relating to small companies and procedural matters of importance in this respect are, therefore, given in the following paragraphs :

1) Letter of Engagement – It is advisable for the auditor to submit to their client and to receive an acknowledgement of the precise scope of their responsibilities both in respect of the audit and any additional work to be undertaken. At the time of engagement, the auditors should explain to the directors management's responsibilities for the preparation of the accounts and establishing a system of internal control appropriate to the needs of the business. The letter should also explain the reliance which the auditors can place upon an effective system. This should subsequently be confirmed in writing, possibly in the engagement letter.

2) Internal control – At an early stage in the audit, the auditors should take care to bring to the directors' attention their findings on the system of internal control.

Problems in small companies arise in the application of auditing principles and procedures. Due to inadequate staff they are unable to apply these principles in totality. These problems mainly arise from :

a) Substantial domination of the accounting and financial functions by one person; and

b) Limitations in the effectiveness from the audit point of view of the system of internal control rendered inevitable by the small number of employees.

Either or both of the above points can be present to a significant extent in most of the small companies.

3) Letter of representations – After discussion with the directors at the conclusion of the audit and before signing the auditor's report, a letter of representation on the company's letter head addressed to the auditors should be obtained. The purpose of such letters is to place on record representation of management on significant matters affecting the account such as the ownership and basis of stating the amount of assets, liabilities, and contingent liabilities such letters, however do not relieve the auditors at any of their responsibilities.

10.5 AUDIT OF HOSPITAL

The special steps involved in such an audit are stated below

1) **Verification of bills:** 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) **Checking cash Collection:** 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) **Collection of revenue:** See by 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 settled on the hospital, has been collected.
4) **Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
5) **Reconciliation of subscription:** 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) **Proper authorization:** 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 authorized.
7) **Government grants:** Verify that grants, if any received from Government or local authority have been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
8) **Reporting of discrepancies:** 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) **Entries in stock register:** 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 Stock Register and that issues have been made only against proper authorization.

10) **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.

11) **Investment registers:** Inspect the bonds, share scrip, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

12) **Physical 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.

10.6 AUDIT OF CLUB

A club is usually constituted as a company limited by guarantee. Therefore, various provisions of the Companies Act, 2013 relating to the audit of accounts of companies are also applicable to its audit. The special steps involved in such as audit are stated below:

a) **Entrance fees:** 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.

b) **Member's subscription:** Vouch member's 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.

c) **Arrears of Subscription:** 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.

d) **Register** of members: Check totals of various columns of the Register of members and tally them across.

e) **Recovery of member's 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.

f) **Other charges made to members**: 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.

g) **Recovery of receivable:** 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.

h) **Record of assets:** Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective stock registers.

i) **Verifying sales:** 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 stock of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.

j) **Physical checking of stock:** Check the stock of furniture, sports material and other assets physically with the respective stock registers or inventories prepared at the end of the year.

k) **Disclosure of investments:** Inspect the share scrip 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.

l) **Verify powers of Secretary:** Examine the financial powers of the secretary and, if these have been exceeded, report specific care for confirmation by the Managing Committee.

10.7 AUDIT OF HOTELS

There are many problems involved in any hotel audit, some of which are peculiar to the hotel industry such as control of cash assume greater proportions.

Almost all sales points in a hotel make both cash and credit sales. The auditor should reconcile the total sales reported with the total of the bills issued by the sales point; this total may take the form of a bill roll or a series of numerically controlled bills. This numerical control must be checked to ensure that all bills are included in the total. The cash element of the sales must then be checked to the cash records and the credit sales in total and detail to the guest’s bills.

The special problems in a hotel audit can be summarized as follows:

1) Internal Controls – Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be over stressed. It is the responsibility of management to introduce controls which will minimize 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.

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 – The charge for room sales is normally posted to guest bills by the receptionist 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 number of guests is charged for the correct period. Any difference between the charge rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorized.

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.

3) Stocks – The stocks in any hotel are both readily portable and saleable particularly the food and beverage stocks. It is therefore extremely important that all movements and transfers of such stocks 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 stock are held should be kept locked, the key being retained by the departmental manager. The key should be released only to trusted personnel and unauthorized 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, it is not unknown for a full crate to be removed in error as an empty crate.

Many hotels use specialized professional valuers to take and value the stocks on a continuous basis throughout the year. Such a valuation is then almost invariably used as the basis of the balance sheet stock figure at the year end. Although such valuers are independent of the audit client, it is important that the auditor satisfies himself of this the auditor should consider attending at the physical stock 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 stock basis. This can lead to confusion between each stock items and similar assets which are accounted for on a more normal fixed assets basis. In such cases it is important that very detailed definitions of stock items exist and the auditor should carry out tests to ensure that the definitions have been closely followed.

5) Casual Labour – The hotel trade operates to very large extent of 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) Other Points:

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 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.

iii) The auditor should ensure that proper records re-maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.

iv) 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.

v) The auditor should see that costs of renovation are treated as deferred revenue expenditure, where as costs of major alterations and additions to the hotel building and facilities capitalised.

vi) The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.

vii) The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities.

viii) In large hotels it is usual to operate a booth to facilitate convertor of foreign currencies to Indian rupees. The auditor should ensure compliance with the various applicable provisions of Foreign Exchange Dealer's Association.

10.8 TAX AUDIT

10.8.1 MEANING

1. Auditor audits financial statements to report about reliability about earning &Financial position of the business entity. Share-holders & interested in audit report. These financial statements provide information to the readers to know about the operating results and financial status of the business entity.

Profit & Loss a/c prepared by accountants discloses Book Profit which is totally different than taxable profit. Such profit requires lot of adjustments to find out taxable profit. e.g. Depreciation allowable under I.T. Rules is different than that of normal ways of calculating depreciation. Expenses / Income not related to business are also considered in P & L A/c Income Tax also permits deductions at prescribed percentages or full amount in certain cases e.g. R & D Expenditure even though it amounts to capital expenditure. Certain payments are totally disallowed while computing taxable business income. Tax has to be deducted on certain payments, to be reported to tax authorities and same has to be remitted to the department within the prescribed time limit. These reasons have created specific information requirements for tax administration.

Income tax authorities do not have sufficient time to look for all such requirements. This has given rise to TAX AUDIT. Tax audit is a specific requirement under the Income Tax Act. It is required in addition to financial audit, which does not fulfill the specific requirements of the tax authority.

The Hon. Finance Minister introduced Compulsory Tax Audit while presenting the Union Budget for 1984-85. The compulsory tax audit is intended to ensure proper maintenance of books of accounts and records. This facilities the tax authorities to tax true income of assessed as well as it saves considerable time of assessing officer for completing Income Tax Assessment.

The income tax act, 1961, contains a numbers of provisions which require audit or certification for tax purposes, e.g. sections 12A.33AB, 33ABA, 35D 35E, 44AB, 44DA, 80HH, 80 HHB,

80HHNA, 80HHC, 80HHD, 80HHE, 80HHF, 80I, 80IA, 80IB, 80IC, 80JJA, 80LA, 115JB and 142[2A]

10.8.2. Types of Tax Audit

Considering requirements of above sections, Tax Audit can be classified in three types as under:

a) Compulsory Tax Audit u/s 44AB
b) Selective tax audit u/s 142[2A]
c) Tax Audit for claiming certain exemptions

10.8.3. Scope of Auditors Role under Income Tax Act:

Auditors Role under Income Tax Act can be broadly summarized into:

a) Conducting compulsory Tax Audit u/c 44AB.
b) Certifying in prescribed form claiming certain exemptions & deductions, under Income Tax Act
c) Conducting selective audit u/s 142 [2A]
d) Submitting Tax Audit Report under prescribed from
e) Advising clients about Tax planning

10.8.4. COMPULSORY TAX AUDIT

The tax audit was introduced by Section 11 of Finance Act, 1984. section 44AB was inserted in Income Tax Act, with effect from assessment year 1985-86. The 44AB section stipulates that every person carrying on business is required to get his accounts audited by a chartered accountant before the "specified date" and furnish by that date the report of such audit, whose total turnover or gross receipts exceed a sum of 2 crore rupees in any previous year (N.A applicable to the persons who opts for presumptive taxation scheme) or any person pursuing profession and whose gross profits exceed fifty lakh rupees in any previous year or A person who is considered eligible for the presumptive taxation scheme. This provision is applicable to the taxpayers who opt for presumptive taxation scheme other than the one who choose the scheme under Section 44AD and whose sale or turnover is limited to Rs 2 crores - vide section 44AB.

i) Certain entities like a company or co-operative society must get their accounts audited under specific laws. Such entities are not required to undergo another tax audit under Section 44AB. Given this scenario, the concerned taxpayer merely needs to obtain and furnish the particular audit report, supported by a report of a chartered accountant in either Form 3CA or 3CB. The particulars for the same must be reported in Form 3CD.

ii) A person who is considered eligible for the presumptive taxation scheme, and who claims that the profits and gains for the respective business is lower than what is computed in accordance with the presumptive taxation scheme and his/her income exceeds the amount that is taxable

This section makes it obligatory for a person caring on Business/Profession to get his accounts audited by a Chartered Accountant and furnish tax audit report in the prescribed from by the specified date, if the total turnover or gross receipts in business in the relevant previous year exceed the prescribed limits. With effect from assessment year 2018-2019, threshold turnover/gross receipts limits for Compulsory Audit of accounts increased to Rs. 2 Crore for business and Rs. 60 lakhs for profession. Certain exceptions are provided under the selection in respect of business even if gross receipts etc. exceed the specified limit. e.g. assesses adopting for presumptive taxation. The following assesses enjoying presumptive taxation are outside the preview of compulsory tax audit.

i) U/S.44B for computing profits and gains of shipping business in the case of non-residents.

ii) U/S.44BB Non residents deriving income from the business of exploration of minerals oils

iii) U/S 44BBB foreign companies engaged in the business of civil construction in certain turnkey projects

iv) U/S 44AD is designed to give relief to small taxpayers engaged in any business (except the business of plying, hiring or leasing of goods carriages referred to in section 44AE).

v) U/S 44AE can be adopted by a person who is engaged in the business of plying, hiring or leasing of goods carriages and who does not own more than 10 goods vehicles at any time during the year.

10.8.5. Penalty for Non Compliance:

According to Section 271B, if a person fails to comply with the provision as to compulsory audit U/S44AB of Income Tax Act or fails to furnish such report, he will be required to pay by way of penalty, as under:

i) A sum equal 0.5% of total sales, or gross receipts in the relevant previous year, OR

ii) Rs. 1 lakh, Whichever is less.

However, section 273B provides that no penalty shall be imposed if the assessee proves that there was reasonable cause for such a non-compliance e.g. Strike in the Office, death of Auditor just before signing audit report.

10.8.6. Definition of Tax Auditor:

The tax audit report has to be certified by Accountant's defined in the Income Tax Act. Accountant, means a practicing Chartered Accountant within meaning of the Chartered Accountant Act 1949. The Chartered Accountant must be holding certificate of practice and also includes a person who u/s.141 of the Companies Act 2013, is entitled to be appointed as an auditor of company. It is not necessary that statutory Auditor should be appointed as Tax Auditor. Any practicing Chartered Accountants can be also be appointed as Tax Auditor. Name of the partner who conducted audit & signed Audit Report should be stated along with his membership number.

10.8.7. Appointment of Tax Auditor:

1. In case of a Company:

Board of Directors can appoint the Tax Auditor to audit accounts of the company. There is no need or requirement of approval by share-holders in A.G.M.

2. In case of Partnership firm:

A partner of the firm or a person authorized by partners on their behalf can appoint Tax Auditor. Partnership Deed may have clause for appointment of Auditors / Tax Auditor.

3. In case Proprietorship concern:

The Proprietor or a person authorized by the proprietor can appoint Tax Auditor.

4. In any other business concern:

Management of the organization or any other person authorized by management, can appoint tax auditor.

5. The assessee may appoint two or more Chartered Accountants as Joint Auditors for the purpose of carrying on tax audit. In such a case all appointed Joint Auditors have to sign Financial Statements as well as Tax Audit Report.

NOTE: The Institute of the Chartered Accountant of India has prescribed a ceiling of 30 tax audits per Chartered Accountant as a self-regulatory measure among Chartered Accountants.

10.8.8. Persons who can not be appointed as Tax Auditor:

The Guidance Note on Tax Audit u/s 44AB issued by ICAI has disqualified following persons who can not be appointed as Tax Auditor:

a) Internal Auditor who is employee of the assesse.

b) A Chartered Accountant who is responsible for writing or maintaining of books of accounts of the assessee.
c) A relative of a Director cannot be appointed as tax auditor of the company.
d) A relative or an employee of assesse cannot be appointed as tax auditor
e) The audit of accounts of professional firm of Chartered Accountants u/s 44AB can not be conducted by any partner or employee of the firm.

10.8.9. Removal of Tax Auditor:

Once Tax Auditor is appointed in the normal course, he should not be removed during the period of his appointment. However management can remove a tax auditor, if there are valid / reasonable grounds for such removal. e.g. After his appointment the said person becomes person of unsound mind., disturbing clients day today work beyond tolerances.

10.8.10. The specified date:

The Tax Auditor has to furnish tax audit report in the prescribed from by the specified date:

The specified date in relation to the account of previous year relevant to an assessment year means:

a) Where the assessee is a company, the 30th day of November of the assessment year.
b) In any other case, the 31st day of October of the assessment year.

10.8.11. Definition of Business / Profession / Vocation:

Business simply means production and/or distribution of goods or services with a view to earn profit. Section 2[13] defines the term “business” as: business includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture. Business means any activity carried on continuously and systematically with a view to earn profit.

Profession means an occupation involving intellectual work requiring special knowledge and having professional qualification, such as doctor, architect, cost accountant etc. As per Section 2[36] Profession includes vocation. Vocation means an occupation involving manual skill such as singing, dancing painting etc. However Income Tax Act does not make any distinction between Business or profession or vocation, method of computation of taxable income in same.

Section 44B does not distinguish between two business or profession carried on by the same assesse. If turnover of both the proprietary concerns, combined together exceeds the prescribed limits then such person has to get his books of accounts audited.

10.8.12. Meaning of Sales and Turnover:

The Income Tax Act does not define the term 'Sale' and 'turnover'. The guidance note issued by the Institute of Chartered Accountants of India [ICAI] on the subject suggests that:

i] These terms should be interpreted with reference to their normally accepted commercial meaning, and

ii] The method of accounting followed by the assessee is also relevant for the determination of 'sales' or 'turnover'

On the basis of the interpretation of these terms, the ICAI, in its earlier pronouncements, has adopted following view regarding what constitutes sales:

a] Sales includes sale of by-product scrap even though such sales are credited to 'miscellaneous income a/c'

b] Sales should be net of trade discount turnover discount, goods returned, price discount and cancellation of bills.

c] Commission allowed to third parties, cash discount, bad debts written off, Royalty, etc. should not be adjusted against sales and should be debited separately to profit & loss a/c.

d] If sales price includes excise duty or sales tax [VAT], no adjustment in respect thereof should be made. In case these taxes are accounted separately, and taxes collected are credited to Excise to Vat a/c and amount paid debited to excise or Vat a/c Then excise duty or sales tax [vat] would not be included in the turnover. Thus treatment of excise duty or sales tax [vat] depends on the accounting practice usually followed.

e] If sales invoices /bills include extra and ancillary charges such as packing, carriage etc. such bills are called composite bills, then total billed amount is to considered as turnover. Incase extra and ancillary charges are accounted separately [even though it shown invoice separately] as reimbursements of costs, then it should not be added to sales/turnover.

f] Sales/Turnover does not include sale proceeds of Fixed Assets of property or Shares/Debentures/Securities, as investments.

g] Sales by a commission agent or consignment basis, should be treated as sale of such person only if the property in goods belongs to him immediately before the transfer of such goods by him to the buyer.

If the property in the goods continuously belongs to the principal till time of sale then it should be included in sales. To whom the property in goods belong at the of sale is a matter to be determined by examining the facts of each case.

10.8.13. Meaning of 'Gross Receipts'

According to the guidance notes on Tax Audit u/s 44AB of the Income Tax Act, issued by the ICAI, Gross receipts refer to all receipts arising from carrying on the business, which would normally be assessable as business income under Income Tax Law. The following items of income and/or receipts would be covered by the term 'Gross Receipts'.

1. Profit on sale of license granted under imports
2. Cash incentives for exports
3. Liquidation damages
4. Insurance claim except for Fixed Assets
5. Interest received by a moneylender
6. Hire charges of cold storage.
7. Sales proceeds of scrap, wastages unless treated as part of sale of turnover
8. Lease Rent.
9. Hiring charges and installments received in course of hire purchase.

In case of money received as reimbursement of expanses incurred, such as packing, forwarding, insurance etc. are credited to a separate account only the net surplus on this account should be added to turnover.

The following items would not from part of 'Gross Receipts' for purpose of Section 44 AB

a) Sale proceeds of fixed assets
b) Sales proceeds of asset held as investments.
c) Rental income unless the same is assessable as business income
d) Dividend on shares except in case of assesses dealing in Shares.
e) Income by way of interest unless assessable as business income.
f) Reimbursement of custom duty and other charges collected by a clearing agent.

In case of a professional, money received as reimbursement of expenses incurred on behalf of client does not form part of his gross receipts provided these are credited to a separate account and are utilized for wholly & solely for the purpose of meeting expenses incurred on behalf of client.

Similarly amount received from client does not from a part of Gross receipt because services are yet to be rendered.

10.8.14 PROCEDURE TO CONDUCT A TAX AUDIT

Unlike Statutory audit, Tax Audit under section 44 AB is not confined to only to Company Audit. Tax Auditor not only has to certify about Financial Statements and report on that but also report on various income tax compliances. Auditor should apply the generally accepted practice and procedures of auditing.

The auditors should get the Financial Statements and other particulars authenticated by the assesse before he starts Tax Audit.

The auditor should verify Internal Control system prevalent in the entity and the materiality of various transactions. then he can prepare audit programme and apply various audit techniques of test checking or statistical sampling.

While conducting tax audit, auditor should keep in mind that the primary object of tax audit, is to assist the tax authorities in assessing the correct taxable income of the assessee. In conducting tax audit, Auditor has to develop skill of combination of general auditing principles and various taxation Laws. Auditor has to check the compliances of various mandatory accounting standards issued by ICAI.

According to the guidance notes on tax Audit u/s 44 AB of the Income Tax Act, issued by the ICAI, it is necessary that Auditor should keep detail notes about the evidence, explanations got from client, on which he relied while conducting the tax audit and like as usual he should keep working papers. Auditor should note down following points while conducting tax audit :

a) Nature of client’s business
b) Previous Financial Statements and Reports
c) Names of Account Officers & their performance & works assigned to them
d) Auditor should prepare Tax Audit Questionnaire and ask the client to answer it in writing, so auditor can get required information for conduct of efficient audit, Questionnaire should include :

i) Accounting Standards followed
ii) All significant accounting policies to be disclosed

iii) Any change in accounting policy, having material effect on profit and / or financial position of the organization.
iv) Prior period item to be shown separately
v) Extraoradinary items of enterprise to be disclosed
vi) Change in method of valuation of inventory
vii) Change in method of charging depreciation

e) Audit work done & by whom
f) Information & explanation given to him during course of audit & by whom.
g) Various certificates issued by client / management
h) Decisions taken by the management on various points affecting tax audit

Above points can be noted, it helps auditors to prepare audit report in from NO. 3CA, 3CB, AND 3CD

1. FORMATS FOR TAX AUDIT

FORM NO. 3CA
[See rule 6G(1)(a)]

Audit report under section 44AB of the Income - tax Act, 1961, in a case where the accounts of the business or profession of a person have been audited under any other law

*I / we report that the statutory audit of M/s. __________________ (Name and address of the asseessee with Permanent Account Number) was conducted by *me / us / M/s. ___________________ in pursuance of the provisions of the____________________Act, and*I/we annex hereto a copy of *my / our / their audit report dated ________________________along with a copy of each of :-

(a) the audited *profit and loss account / income and expenditure account for the period beginning from ---------------------to ending on -----------------------------.

(b) the audited balance sheet as at, _____; and

(c) documents declared by the said Act to be part of, or annexed to, the *profit and loss account / income and expenditure account and balance sheet.

2. The statement of particulars required to be furnished under section 44AB is annexed herewith in Form No. 3CD.

3. In *my / our opinion and to the best of *my / our information and according to examination of books of account including other relevant documents and explanations given to *me / us, the

particulars given in the said Form No.3 CD are true and correct subject to the following observations/qualifications, if any:

a.

b.

c.

…………...
**(Signature and stamp/Seal of the signatory)

Place : _____________ Name of the signatory ………………………

Date : ______________Full address ………………………………….

Notes :

1. * Delete whichever is not applicable
2. **This report has to be signed by a person eligible to sign the report as per the provisions of section 44AB of the Income Tax Act, 1961.
3. Where any of the requirements in this Form is answered in the negative or with qualification, give reasons therefore.
4. The person who signs this audit report shall indicate reference of his membership number / certificate of practice / authority under which he is entitled to sign this report.

FORM NO. 3CB
[See rule 6G(1)(b)]
Audit report under section 44AB of the Income - tax Act 1961, in the case of a person referred to in clause (b) of sub - rule (1) of rule 6G

1. *I / we have examined the balance sheet as on, ____, and the *profit and loss account / income and expenditure account for the period beginning from ---------------------to ending on -----------------., attached herewith, of ______________________________(Name), _______________(Address), ____________(Permanent Account Number).

2. *I / we certify that the balance sheet and the *profit and loss / income and expenditure account are in agreement with the books of account maintained at the head office at _____________ and ** ___________ branches.

3.(a) *I / we report the following observations / comments / discrepancies / inconsistencies; if any:

(b) Subject to above, -

(A) *I / we have obtained all the information and explanations which, to the best of *my / our knowledge and belief, were necessary for the purpose of the audit.

(B) In *my / our opinion, proper books of account have been kept by the head office and branches of the assesseeso far as appears from*my / our examination of the books.

(C) In *my / our opinion and to the best of *my / our information and according to the explanations given to *me / us, the said accounts, read with notes thereon, if any, give a true and fair view :-

(i) in the case of the balance sheet, of the state of the affairs of the assessee as at 31st March, ;and

(ii) in the case of the *profit and loss account / income and expenditure account of the *profit / loss or *surplus / deficit of the assessee for the year ended on that date.

4. The statement of particulars required to be furnished under section 44AB is annexed herewith in Form No.3CD.

5. In *my/our opinion and to the best of *my / our information and according to explanations given to *me / us, the particulars given in the said Form No.3 CD are true and correct subject to following observations/qualifications, if any:

a.

b.

c. ……………..

***(Signature and stamp/seal of the signatory)

Place : ______________Name of the signatory ………………………
Date : _______________Full address ………………………………….

Notes :

1. *Delete whichever is not applicable.
2. **Mention the total number of branches.
3. ***This report has to be signed by person eligible to sign the report as per the provisions of section 44AB of the Income Tax Act, 1961.

4. The person, who signs this audit report, shall indicate reference of his membership number / certificate of practice number / authority under which he is entitled to sign this report.

FORM NO. 3CD

[See rule 6 G(2)]

Statement of particulars required to be furnished under section 44AB of the Income Tax Act, 1961

PART - A

1. Name of the assessee

2. Address

3. Permanent Account Number (PAN)

4. Whether the assessee is liable to pay indirect tax like excise duty, service tax, sales tax, customs duty,etc. if yes, please furnish the registration number or any other identification number allotted for the same

5. Status

6. Previous year from……………..to ……………

7. Assessment year

8. Indicate the relevant clause of section 44AB under which the audit has been conducted

PART - B

9. (a) If firm or association of persons, indicate names of partners/members and their profit sharing ratios.

(b) If there is any change in the partners or members or in their profit sharing ratio since the last date of the preceding year, the particulars of such change

10. (a) Nature of business or profession (if more than one business or profession is carried on during the previous year, nature of every business or profession)

(b) If there is any change in the nature of business or profession, the particulars of such change.

11. (a) Whether books of account are prescribed under section 44AA, if yes, list of books so prescribed.

(b) List of books of account maintained and the address at which the books of accounts are kept.

(In case books of account are maintained in a computer system, mention the books of account generated by such computer system. If the books of accounts are not kept at one location, please furnish the addresses of locations along with the details of books of accounts maintained at each location.)

(c) List of books of account and nature of relevant documents examined.

12. Whether the profit and loss account includes any profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant section (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB, Chapter XII-G, First Schedule or any other relevant section.)

13.(a) Method of accounting employed in the previous year

(b) Whether there had been any change in the method of accounting employed vis-a-vis the method employed in the immediately preceding previous year.

(c) If answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the profit or loss.

Serial number	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)

(d) Whether any adjustment is required to be made to the profits or loss for complying with the provisions of income computation

(e) If answer to (d) above is in the affirmative, give details of such adjustments:

		Increase in Profit (Rs.)	**Decrease in Profit (Rs.)**	**Net Effect (Rs.)**
ICDS I	Accounting Policies			
ICDS II	Valuation of Inventories			
ICDS III	Construction Contracts			
ICDS IV	Revenue Recognition			
ICDS V	Tangible Fixed Assets			

ICDS VI	Changes in Foreign Exchange Rates			
ICDS VII	Governments Grants			
ICDS VIII	Securities			
ICDS IX	Borrowing Costs			
ICDS X	Provisions, Contingent Liabilities and contingent assets			
Total				

(f) Disclosure as per ICDS:

i) ICDS-I Accounting Policies
ii) ICDS-II Valuation of Inventories
iii) ICDS-III Construction Contracts
iv) ICDS-IV Revenue Recognition
v) ICDS-V Tangible Fixed Assets
vi) ICDS-VII Governments Grants
vii) ICDS-IX Borrowing Costs
viii) ICDS-X Provisions, Contingent Liabilities and contingent Assets

14. (a) Method of valuation of closing stock employed in the previous year.

(b) In case of deviation from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss, please furnish:

Serial number	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)

15. Give the following particulars of the capital asset converted into stock-in trade: -

(a) Description of capital asset;

(b) Date of acquisition;

(c) Cost of acquisition;

(d) Amount at which the asset is converted into stock-in-trade.

16. Amounts not credited to the profit and loss account, being, -

(a) the items falling within the scope of section 28;

(b) the pro forma credits, drawbacks, refund of duty of customs or excise or service tax, or refund of sales tax or value added tax where such credits, drawbacks or refunds are admitted as due by the authorities concerned;

(c) escalation claims accepted during the previous year;

(d) any other item of income;

(e) capital receipt, if any.

17. Where any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C, please furnish:

Details of property	Consideration received or accrued	Value adopted or assessed or assessable

18. Particulars of depreciation allowable as per the Income Tax Act, 1961 in respect of each asset or block of assets, as the case may be, in the following form :-

(a) Description of asset/block of assets.

(b) Rate of depreciation.

(c) Actual cost of written down value, as the case may be.

(d) Additions/deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of –

i) Central Value Added Tax credits claimed and allowed under the Central Excise Rules, 1944, in respect of assets acquired on or after 1st March, 1994,

ii) change in rate of exchange of currency, and

iii) subsidy or grant or reimbursement, by whatever name called.

(e) Depreciation allowable.

(f) Written down value at the end of the year

19. Amounts admissible under sections:

Section	Amount debited to profit and loss account	Amounts admissible as per the provisions of the Income Tax Act, 1961 and also fulfils the conditions, if any specified under the the conditions, if any specified under the relevant 14provisions of Income Tax Act, 1961 or Income Tax Rules,1962 or any other guidelines, circular, etc., issued in this behalf.

32AC		
33AB		
33ABA		
35(1)(i)		
35(1)(ii)		
35(1)(iia)		
35(1)(iii)		
35(1)(iv)		
35(2AA)		
35(2AB)		
35ABB		
35AC		
35AD		
35CCA		
35CCB		
35CCC		
35CCD		
35D		
35DD		
35DDA		
35E		

20. (a) Any sum paid to an employee as bonus or commission for services rendered, where such sum was otherwise payable to him as profits or dividend. [Section 36(1)(ii)]

(b) Details of contributions received from employees for various funds as referred to in section 36(1)(va):

Serial number	Nature of fund	Sum received from employees	Due date for payment	The actual amount paid	The actual date of payment to the concerned authorities

21. (a) Please furnish the details of amounts debited to the profit and loss account, being in the nature of capital, personal, advertisement expenditure etc

Nature	Serial number	Particulars	Amount in Rs.
Expenditure incurred at clubs being cost for club services and facilities used.			
Expenditure by way of penalty or fine for violation of any law for the time being force			
Expenditure by way of any other penalty or fine not covered above			
Expenditure incurred for any purpose which is an offence or which is prohibited by law			

(b) Amounts inadmissible under section 40(a):-
(i) as payment to non-resident referred to in sub-clause (i)

(A) Details of payment on which tax is not deducted:
(I) date of payment
(II) amount of payment
(III) nature of payment
(IV) name and address of the payee

(B) Details of payment on which tax has been deducted but has not been paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)
(I) date of payment
(II) amount of payment
(III) nature of payment
(IV) name and address of the payee
(V) amount of tax deducted
(ii) as payment referred to in sub-clause (ia)

(A) Details of payment on which tax is not deducted:
(I) date of payment
(II) amount of payment
(III) nature of payment
(IV) name and address of the payee

(B) Details of payment on which tax has been deducted but has not been paid on or before the due date specified in sub- section (1) of section 139.
(I) date of payment
(II) amount of payment
(III) nature of payment

(IV) name and address of the payer
(V) amount of tax deducted
(VI) amount out of (V) deposited, if any
(iii) under sub-clause (ic) [Wherever applicable]
(iv) under sub-clause (iia)
(v) under sub-clause (iib)
(vi) under sub-clause (iii)

(A) date of payment

(B) amount of payment

(C) name and address of the payee
(vii) under sub-clause (iv)
(viiii) under sub-clause (v)

(c) Amounts debited to profit and loss account being, interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof;

(d) Disallowance/deemed income under section 40A(3):

(A) On the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details:

Serial number	Date of payment	Nature of payment	Amount	Name and Permanent Account Number of the payee, if available

(B) On the basis of the examination of books of account and other relevant documents/evidence, whether the payment referred to in section 40A(3A) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft If not, please furnish the details of amount deemed to be the profits and gains of business or profession under section 40A(3A);

Serial number	Date of payment	Nature of payment	Amount	Name and Permanent Account Number of the payee, if available

(e) provision for payment of gratuity not allowable under section 40A(7);

(f) any sum paid by the assessee as an employer not allowable under section 40A(9);

(g) particulars of any liability of a contingent nature;

(h) amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income;

(i) amount inadmissible under the proviso to section 36(1)(iii).

22. Amount of interest inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

23. Particulars of payments made to persons specified under section 40A(2)(b).

24. Amounts deemed to be profits and gains under section 32AC or 33AB or 33ABA or 33AC.

25. Any amount of profit chargeable to tax under section 41 and computation thereof.

26. In respect of any sum referred to in clause (a),(b), (c), (d), (e) or (f) of section 43B, the liability for which:-

(A) pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding previous year and was

(a) paid during the previous year;

(b) not paid during the previous year;

(B) was incurred in the previous year and was

(a) paid on or before the due date for furnishing the return of income of the previous year under section 139(1);

(b) not paid on or before the aforesaid date.

(State whether sales tax, customs duty, excise duty or any other indirect tax, levy, cess, impost, etc., is passed through the profit and loss account.)

27. (a) Amount of Central Value Added Tax credits availed of or utilised during the previous year and its treatment in the profit and loss account and treatment of outstanding Central Value Added Tax credits in the accounts. (b) Particulars of income or expenditure of prior period credited or debited to the profit and loss account.

28. Whether during the previous year the assessee has received any property, being share of a company not being a company in which the public are substantially interested, without consideration or for inadequate consideration as referred to in section 56(2)(viia), if yes, please furnish the details of the same.

29. Whether during the previous year the assessee received any consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib), if yes, please furnish the details of the same.

30. Details of any amount borrowed on hundi or any amount due thereon (including interest on the amount borrowed) repaid, otherwise than through an account payee cheque. [Section 69D]

31. (a) Particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year : -

(i) name, address and Permanent Account Number (if available with the assessee) of the lender or depositor;

(ii) amount of loan or deposit taken or accepted;

(iii) whether the loan or deposit was squared up during the previous year;

(iv) maximum amount outstanding in the account at any time during the previous year;

(v) whether the loan or deposit was taken or accepted by cheque or bank draft or use of electronic clearing system through a bank account;

(vi) in case the loan or deposit was taken or accepted by cheque or bank draft, whether the same was taken or accepted by an account payee cheque or an account payee bank draft.

(b) Particulars of each specified sum in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year: -

(i) name, address and Permanent Account Number (if available with the assessee) of the person from whom specified sum is received;

(ii) amount of specified sum taken or accepted;

(iii) whether the specified sum was taken or accepted by cheque or bank draft or use of electronic clearing system through a bank account;

(iv) in case the specified sum was taken or accepted by cheque or bank draft, whether the same was taken or accepted by an account payee cheque or an account payee bank draft. (Particulars at (a) and (b) need not be given in the case of a Government company, a banking company or a corporation established by the Central, State or Provincial Act.)

(c) Particulars of each repayment of loan or deposit or any specified advance in an amount exceeding the limit specified in section 269T made during the previous year:-

(i) name, address and Permanent Account Number (if available with the assessee) of the payee;

(ii) amount of the repayment;

(iii) maximum amount outstanding in the account at any time during the previous year;

(iv) whether the repayment was made by cheque or bank draft or use of electronic clearing system through a bank account;

(v) in case the repayment was made by cheque or bank draft, whether the same was taken or accepted by an account payee cheque or an account payee bank draft.

(d) Particulars of repayment of loan or deposit or any specified advance in an amount exceeding the limit specified in section 269T received otherwise than by a cheque or bank draft or use of electronic clearing system through a bank account during the previous year:—

(i) name, address and Permanent Account Number (if available with the assessee) of the lender, or depositor or person from whom specified advance is received;

(ii) amount of loan or deposit or any specified advance received otherwise than by a cheque or bank draft or use of electronic clearing system through a bank account during the previous year.

(e) Particulars of repayment of loan or deposit or any specified advance in an amount exceeding the limit specified in section 269T received by a cheque or bank draft which is not an account payee cheque or account payee bank draft during the previous year:—

(i) name, address and Permanent Account Number (if available with the assessee) of the lender, or depositor or person from whom specified advance is received;

(ii) amount of loan or deposit or any specified advance received by a cheque or a bank draft which is not an account payee cheque or account payee bank draft during the previous year. (Particulars at (c), (d) and (e) need not be given in the case of a repayment of any loan or deposit or any specified advance taken or accepted from the Government, Government company, banking company or a corporation established by the Central, State or Provincial Act). 32.(a) Details of brought forward

32.(a) Details of brought forward loss or depreciation allowance, in the following manner, to the extent available :

Serial Number	Assessment Year	Nature of loss / allowance (in rupees)	Amount as returned (in rupees)	Amounts as assessed (give reference to relevant order)	Remarks

(b) Whether a change in shareholding of the company has taken place in the previous year due to which the losses incurred prior to the previous year cannot be allowed to be carried forward in terms of section 79.

(c) Whether the assessee has incurred any speculation loss referred to in section 73 during the previous year, If yes, please furnish the details of the same.

(d) whether the assessee has incurred any loss referred to in section 73A in respect of any specified business during the previous year, if yes, please furnish details of the same.

(e) In case of a company, please state that whether the company is deemed to be carrying on a speculation business as referred in explanation to section 73, if yes, please furnish the details of speculation loss if any incurred during the previous year.

33. Section-wise details of deductions, if any, admissible under Chapter VIA or Chapter III (Section 10A, Section 10AA).

Section under which deduction is claimed	Amounts admissible as per the provision of the Income Tax Act, 1961 and fulfils the conditions, if any, specified under the relevant provisions of Income Tax Act, 1961 or Income Tax Rules,1962 or any other guidelines, circular, etc, issued in this behalf.

34. (a) Whether the assessee is required to deduct or collect tax as per the provisions of Chapter XVII-B or Chapter XVII-BB, if yes please furnish:

Tax deduction and collection Account Number (TAN)	Section	Nature of payment	Total amount of payment or receipt of the nature specified in column (3)	Total amount on which tax was required to be deducted or collected out of (4)	Total amount on which tax was deducted or collected at specified rate out of (5)	Amount of tax deducted or collected out of (6)	Total amount on which tax was deducted or collected at less than specified rate out of (7)	Amount of tax deducted or collected on (8)	Amount of tax deducted or collected not deposited to the credit of the Central Government out of (6) and (8)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)

(b) whether the assessee has furnished the statement of tax deducted or tax collected within the prescribed time. If not, please furnish the details:

Tax deduction and collection Account Number (TAN)	Type of Form	Due date for furnishing	Date of furnishing, if furnished	Whether the statement of tax deducted or collected contains information about all transactions which are required to be reported

(c) whether the assessee is liable to pay interest under section 201(1A) or section 206C(7). If yes, please furnish:

Tax deduction and collection Account Number (TAN)	Amount of interest under section 201(1A)/206C(7) is payable	Amount paid out of column (2) along with date of payment.

35. (a) In the case of a trading concern, give quantitative details of principal items of goods traded :

(i) Opening Stock;

(ii) purchases during the previous year;

(iii) sales during the previous year;

(iv) closing stock;

(v) shortage/excess, if any

(b) In the case of a manufacturing concern, give quantitative details of the principal items of raw materials, finished products and by-products :

A. Raw Materials :

(i) opening stock;

(ii) purchases during the previous year;

(iii) consumption during the previous year;

(iv) sales during the previous year;

(v) closing stock;

(vi) yield of finished products;

(vii) percentage of yield;

(viii) shortage/excess, if any.

B. Finished products/by- products :

(i) opening stock;

(ii) purchases during the previous year;

(iii) quantity manufactured during the previous year;

(iv) sales during the previous year;

(v) closing stock;

(vi) shortage/excess, if any.

36. In the case of a domestic company, details of tax on distributed profits under section 115-O in the following form :-

(a) total amount of distributed profits;

(b) amount of reduction as referred to in section 115-O(1A)(i);

(c amount of reduction as referred to in section 115-O(1A)(ii);

(d) total tax paid thereon;

(e) dates of payment with amounts.

37. Whether any cost audit was carried out, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor.

38. Whether any audit was conducted under the Central Excise Act, 1944, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor.

39. Whether any audit was conducted under section 72A of the Finance Act,1994 in relation to valuation of taxable services, Finance Act,1994 in relation to valuation of taxable services, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor.

40. Details regarding turnover, gross profit, etc., for the previous year and preceding previous year:

Serial number	Particulars	Previous year	Preceding previous year
1.	Total turnover of the assessee		
2.	Gross profit/turnover		
3.	Net profit/turnover		
4.	Stock-in-trade/turnover		
5.	Material consumed/finished goods produced		

(The details required to be furnished for principal items of goods traded or manufactured or services rendered)

41. Please furnish the details of demand raised or refund issued during the previous year under any tax laws other than Income Tax Act, 1961 and Wealth tax Act, 1957 along with details of relevant proceedings.

……………..
*(Signature and stamp/Seal of the signatory)

Place : ______________ Name of the signatory
Date : ______________ Full address

Notes :

1. *This Form has to be signed by the person competent to sign Form No. 3CA or Form No. 3CB, as the case may be.

10.9 QUESTIONS

1. Explain the audit procedure for sole trader.
2. What are the important points in audit of Partnership Firm?
3. What are the advantages of audit Partnership Firm?
4. Explain format of audit report of Sole Proprietorship Firm.
5. Explain format of audit report of Partnership Firm.
6. Explain the audit procedure for audit procedure for audit of small companies.
7. Explain the steps involved in audit of a Hospital.
8. How audit of a club should be conducted?
9. Explain the important points in audit of Hotels.
10. Explain the provisions of Income Tax Audit.
11. What is the procedure to conduct tax audit?

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11

AUDIT OF INSURANCE COMPANIES

Unit Structure

11.1 INTRODUCTION

Insurance is a contract of indemnity between insurer and insured. The insurance may be classified as life insurance and general insurance. The business of insurance is now superintended and regulated by Insurance Regulatory and Development Authority (IRDA).

11.2 LEGAL FRAMEWORK

It is important for the auditor to familanise himself with various statutes governing the insurance industry. The auditor while familiarizing himself with various rules, regulations, relevant notifications, should also look into the important aspects arising out of those which might have an effect on determination of nature, timing and extent of audit procedures, while performing his role as an auditor.

The primary legislations which deal with the insurance business in India are the Insurance Act, 1938 and the IRDA Act, 1999. Various aspects relating to audit are dealt with around the framework of the following statutes and rules made there under:

(a) The Insurance Act, 1938 (including Insurance Rules, 1939);
(b) The Insurance Regulatory and Development Authority Act, 1999;
(c) The Insurance Regulatory and Development Authority Regulations framed under the IRDA, Act, 1999;
(d) The Companies Act, 1956; and
(e) The General Insurance Business (Nationalization) Act, 1972 (including Rules framed thereunder).

Some relevant statutory provisions are discussed below:

1. Insurer:

Section 2(9) of the Insurance Act, 1938 (hereinafter referred to as the ‘Act’) defines the term ‘Insurer’ as:

(a) any individual or unincorporated body of individuals or body corporate incorporated under the law of any country other than India, carrying on insurance business not being a person specified in sub-clause (c) of this clause which-

(i) carries on that business in India, or
(ii) has his or its principal place of business, employs a representative, or maintains a place of business in India;

(b) anybody corporate not being a person specified in sub-clause (c) of this clause carrying on the business of insurance, which is a body corporate incorporated under any law for the time being in force in India; or stands to any such body corporate in the relation of a subsidiary company within the meaning of the Indian Companies Act, 1973, (7 of 1913), as defined by sub-section (2) of section 2 of that Act; and

(c) any person who in India has a standing contract with underwriters who are members of the Society of Lloyd’s whereby such person is authorized within the terms of such contract to issue protection notes, cover notes, or other documents granting insurance cover to others on behalf of the underwriters,

But does not include a principal agent, special agent, or an insurance agent or a provident society.

2. Policy Holder:

Section 2(2) of the Insurance Act, 1938 defines the term policy holder as a person to whom the whole of the interest of the policy holder in the policy is assigned once and for all, but does not include as assigner thereof whose interest in the policy is defensible or is for the time being subject to any condition.

3. Requirements as to the Minimum Paid-up Capital:

The minimum paid-up equity share capital of an Indian Insurance Company carrying on general insurance business should be Rs 100 crores or more, excluding deposits under Section 7 of the Insurance Act, 1938 and preliminary expenses incurred in the formation and registration of company. The management of an insurance company needs to certify the pattern of shareholding as on every Balance Sheet date.

4. Deposits:

Section 7 of the Insurance Act, 1938 requires every insurer, carrying a general insurance business, to deposit and keep deposited with RBI in it’s one of the offices in India a sum equivalent to three percent of total gross premium written in India in any financial year. The maximum limit of deposit under this section is Rupees ten crores. The deposit is to be for and on behalf of the Government of India.

5. Separation of Accounts and Funds

Where the insurer carries on business of more than one of the following classes, namely, life insurance, fire insurance, marine insurance or miscellaneous insurance, he shall keep a separate account of all receipts and payment in respect of each such class of insurance business.

6. Accounts and Balance Sheet

Every insurer, in respect of insurance business transacted by him and in respect of his shareholders' funds, shall, at the expiration of each financial year, prepare with reference to that year-

A balance sheet,

A profit and loss account,

A separate account of receipts and payments,

A revenue account in accordance with the regulations made by the IRDA,

A separate account relating to funds of shareholders; and

A separate account relating to funds of policy-holders.

7. Audit

Every insurance company should keep separate account for shareholders fund and the policy holders' fund. The insurance companies are required to prepare financial statements in accordance with IRDA i.e. preparation of financial statements and Auditors Report of Insurance Companies Regulations 2000. The Schedule A to the Regulations contains provisions applicable to life insurance business. Schedule B to the Regulations lays down accounting principles, disclosures forming part of financial statements, Schedule C lays down matter to be covered in Auditor's report of both life and general insurance business.

The balance sheet, profit and loss account, revenue account and profit and loss appropriation account of every insurer, shall, unless they are subject to audit under the Indian Companies Act, be audited annually by an auditor, and the auditor shall in the audit of all such accounts have the powers of, exercise the functions vested in, and discharge the duties and be subject to the liabilities and penalties imposed on auditors of companies by the Indian Companies Act.

11.3 REGISTER OF POLICIES AND REGISTER OF CLAIMS

1. Register of Policies: Every insurer shall maintain a register of record of policies, in which shall be entered, in respect of every policy issued by the insurer, the name and address of the policyholder, the date when the policy was effected and a record of any transfer, assignment or nomination of which the insurer has notice.

2. Register of Claims: Every insurer shall maintain a register or record of claims, in which shall be entered every claim made together with the date of the claim, the name and address of the claimant and the date on which the claim was discharged, or, in the case of a claim which is rejected, the date of rejection and the grounds there for.

11.4 REQUIREMENTS OF SCHEDULE B TO THE IRDA REGULATIONS, 2002

Preparation of Financial Statements and Auditors' Report of Insurance Companies

Preparation of financial statements by life insurer [IRDA regulation 3]

An insurer carrying on life insurance business, after the commencement of IRDA Regulation, must comply with the requirement of Schedule A. Schedule A, is divided into 5 parts:

Part I : Accounting Principles for preparation of Financial Statements.

Part II : Disclosures forming part of Financial Statements

Part III: General Instructions for preparation of Financial Statements

Part IV: Contents of Management Report

Part V : Preparation of Financial Statements:

1. Revenue Account (Policyholders account) in Form A- RA
2. Profit and Loss Account (Shareholders Account) in Form A-PL
3. Balance Sheet in Form A-B5
4. Receipts and Payment Account as per Direct Method prescribed in AS-3 Cash Flow Statement issued by ICAI.

PART I – ACCOUNTING PRINCIPLES FOR PREPARATION OF FINANCIAL STATEMENTS

1. **Applicability of Accounting Standards:** Every Balance Sheet, Receipts and Payments Account [Cash Flow Statement] and Profit and Loss Account [Shareholders' Account] of the insurer shall be in conformity with the Accounting Standards (AS) issued by ICAI, to the extent applicable to the insurers carrying on general insurers carrying on general insurance business, except that:

(i) Account Standard 3 (AS 3) – Cash Flow Statements – Cash Flow Statement shall be prepared only under the Direct Method.

(ii) Accounting Standard 13 (AS 13) – Accounting for Investments, shall not be applicable.

(iii) Accounting Standard 17 (AS 17) – Segment Reporting – shall apply to all insurers irrespective of the requirements regarding listing and turnover mentioned therein.

2. **Premium:** Premium shall be recognized as income over the contract period or the period of risk, whichever is appropriate. Premium received in advance, which represents premium income not relating to the current accounting period, shall be disclosed separately in the financial statements.

A reserve for unexpired risks shall be created as the amount representing that part of the premium written which is attributable to, and to be allocated to the succeeding accounting periods and shall not be less than as required under section 64 V(1)(ii)(b) of the Act.

Premium Received in Advance, which represents premium received prior to the commencement of the risk, shall be shown separately under the head '*Current Liabilities*' in the financial statements.

3. **Premium Deficiency:** Premium deficiency shall be recognized if the sum of expected claim costs, related expenses and maintenance costs exceeds related reserve for unexpired risks.

4. **Acquisition Costs:** Acquisition costs, if any, shall be expensed in the period in which they are those costs that vary with, and are primarily related to, the acquisition of new and renewal of insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts (i.e. commencement of risk).

5. **Claims:** The components of the ultimate cost of claims to an insurer comprise the claims under policies and specific claims

settlement costs. Claims under policies comprise the claims made for losses incurred, and those estimated or anticipated under the policies following a loss occurrence.

A liability for outstanding claims shall be brought to account in respect of both direct business and inward reinsurance business.

The liability shall include:-
(a) Future payments in relation to unpaid report claims;
(b) Claims Incurred But Not Reported(IBNR) including inadequate reserves [sometimes referred to as Claims Incurred but Not Enough Reported (IBNER),

This will result in future cash/asset outgo for settling liabilities against those claims. Change in estimated liability represents the difference between the estimated liability for outstanding claims at the beginning and at the end of the financial period.

The accounting estimate shall also include claims cost adjusted for estimated salvage value if there is sufficient degree of certainty of its realization.

6. Recognition of Surplus arising in non-participating funds as profit/loss in the Profit & Loss Account: Authority vide its CIRCULAR NO. IRDA/F&A/CIR/217/12/2010 dated December 12, 2010, has observed that there is no uniform approach followed by the insurers for transfer of the surplus to the Profit & Loss Account. A few of the insurers are doing it on quarterly basis while a few are doing on yearly basis.

In view of the same, it is clarified that the surplus arising in non-participating funds may be recognized as Profit & Loss Account on quarterly basis provided that

a. Financial Statements are audited on quarterly basis
b. The surplus to be transferred to Profit & Loss Account must be certified and recommended by the Appointed Actuary of the company
c. A disclosure to this effect should be made in the financial statement.
d. In any case the amount transferred must not exceed the yearly profit. The difference if any must be adjusted in the 4th quarter. In case the variation in the surplus is in excess of 10% or 5 crores, which is higher, then the company shall submit to the Authority an explanation stating reasons for variation along with the annual financial statement. The explanation of variation so submitted shall be approved by Board of Directors.

In case of deficit, insurer will continue to follow the existing practices of making the shortfall good by transferring the funds from shareholders account for recognizing the deficit in the profit & loss account on quarterly basis.

Actuarial Valuation of claim liability – in some cases

Claims made in respect of contracts where the claims payment period exceeds four years shall be recognized on an actuarial basis, subject to regulations that may be prescribed by the Authority. in such cases, certificate from a recognized actuary as to the fairness of liability assessment must be obtained. Actuarial assumption shall be suitably disclosed by way of notes to the account.

7. Procedure to determine the value of investments: An Insurer shall determine the values of investments in the following manner:

(a) Real estate – Investment property: Investment property shall be measured at historical cost less accumulated depreciation and impairment loss, residual value being considered zero and no revaluation being permissible.

The Insurer shall assess at each balance sheet date whether any impairment of the investment property has occurred.

An impairment loss shall be recognized as an expense in the Reveune/Profit and Loss Account immediately.

Fair value as at the balance sheet date and the basis of its determination shall be disclosed in the financial statements as additional information.

(b) Debt Securities: Debt securities including government securities and redeemable preference shares shall be considered as “held to maturity” securities shall be measured at historical cost subject to amortization.

(c) Equity Securities and Derivative Instruments that are traded in active markets: Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value as at the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price of the stock exchanges where the securities are listed shall be taken.

The insurer shall assess on each balance sheet date whether any impairment of listed equity security(ies) derivative(s) instruments has occurred.

An active market shall mean a market, where the securities traded are homogenous, availability of willing buyers and willing sellers is normal and the prices are publicly available.

Unrealized gains/losses arising due to changes in the fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'Fair Value Change Account'. The 'Profit on Sale of Investments' or 'Loss on Sale of Investment', as the case may be, shall include accumulated changes in the fair value previously recognized in equity under the heading Fair Value Change Account in respect of a particular security and being security.

For the removal of doubt, it is clarified that balance or any part thereof shall not be available for distribution as dividends. Also, any debit balance in the said Fair Value Change Account shall be reduced from the profits/free reserves while declaring dividends.

The insurer shall assess, at each balance sheet date, whether any impairment has occurred. An impairment loss shall be recognized as an expense in Revenue/Profit and Loss Account to the extent of the difference between the premeasured fair value of the security/investment and its acquisition cost as reduced by any previous impairment loss recognized as expense in Revenue/Profit and Loss Account. Any reversal of impairment loss earlier recognized in Revenue/Profit and Loss Account shall be recognized in Revenue/Profit and Loss Account.

(d) Unlisted and other than actively traded Equity Securities and Derivative Instruments: Unlisted equity securities and derivative instruments and listed equity securities and derivative instruments that are not regularly traded in active market will be measured at historical costs. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of the investment over its carrying amount. The increased carrying amount of the investment due to the reversal of the provision shall not exceed the historical cost.

For the purposes of this regulation, a security shall be considered as being not actively traded, if as per guidelines governing mutual funds laid down from time to time by SEBI, such a security is classified as "thinly traded".

8. **Loans:** Loans shall be measured at historical cost subject to impairment provisions. The insurer shall assess the quality of its loan assets and shall provide for impairment. The impairment provision shall not be lower than the amount derived on the basis of guidelines prescribed from time to time by the Reserve Bank of India that apply to companies and financial institutions.

9. **Catastrophe Reserve:** Catastrophe reserve shall be created in accordance with norms, if any, prescribed by the Authority. Investment of funds out of catastrophe reserve shall be made in accordance with prescription of the Authority.

PART II: DISCLOSURES FORMING PART OF FINANCIAL STATEMENTS

The following shall be disclosed by way of notes to the Balance Sheet-

1. Contingent Liabilities:
(a) Partly-paid up investments
(b) Underwriting commitments outstanding
(c) Claims, other than those under policies, not acknowledged as debts
(d) Guarantees given by or on behalf of the company
(e) Statutory demands/liabilities in dispute, not provided for
(f) Reinsurance obligation to the extent not provided for in accounts
(g) Others (to be specified)

2. Encumbrances to assets of the company in and outside India.

3. Commitments made and outstanding for Loans, Investments and Fixed Assets.

4. Claims, less reinsurance, paid to claimants in/outside India.

5. Actuarial assumptions for determination of claim liabilities in the case of claims where the claims payment period exceed four years.

6. Ageing of claims – distinguishing between claims outstanding for more than six months and other claims.

7. Premiums, less reinsurance, written from business in outside India.

8. Extent of premium income recognized, based on varying risk pattern, category wise, with basis and justification therefor, including whether reliance has been placed on exterenal evidence.

9. Value of contracts in relation to investments, for:

(a) Purchases where deliveries are pending;
(b) Sales where payments are overdue.

10. Operating expenses relating to insurance business: basis of allocation of expenditure to various classes of business.

11. Historical costs of those investments valued on fair value basis.

12. Computation of managerial remuneration.

13. Basis of amortization of debt securities.

14. (a) Unrealized gain/losses arising due to changes in the fair value of listed equity shares and derivative instruments are to be taken to equity under the head 'Fair Value Change Account' and on realization reported in profit & loss account.
(b) Pending realization, the credit balance in the 'Fair Value Change Account' is not available for distribution.

15. Fair Value of investment property and the basis therefore.

16. Claims settled and remaining unpaid for a period of more than six months as on the balance sheet date.

The following accounting policies shall form an integral part of the financial statements-

1. All significant account policies in terms of the accounting standards issued by the ICAI, and significant principles and policies given in Part I of Accounting Principles. Any other accounting policies followed by the insurer shall be stated in the manner required under Accounting Standard AS 1 issued by the ICAI.

2. Any departure from the accounting policies as aforesaid shall be separately disclosed with reasons for such departure.

The following information shall also be disclosed-

1. Investments made in accordance with any statutory requirement should be disclosed separately together with its amount, nature, security and any special rights in and outside India.

2. Segregation into performing/non performing investments for purpose of income recognition as per the directions, if any, issued by the Authority.

3. Percentage of business sector-wise.

4. A summary of financial statements for the last five years, in the manner as may prescribed by the Authority.

5. Accounting Ratios as may be prescribed by the Authority.

6. Basis of allocation of interest, Dividends and Rent between Revenue Account and Profit and Loss Account.

PART III: GENERAL INSTRUCTION FOR PREPARATION OF FININCIAL STATEMENTS

1. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet, Revenue, Account, Profit and Loss Account and Receipts and Payment Accounts should be given.

2. The figures in the financial statements may be rounded off to the nearest thousands.

3. Interest, dividends and rentals receivable in connection with an investment should be stated, as gross value, the amount of income tax deducted at source being included under 'advance taxes paid'.

4. Income from rent shall not include any notional rent.

5. For the purposes of financial statements, unless the context otherwise requires-

(a) The expression 'provision' shall, subject to note II below mean any amount written off or retained by way of providing for depreciation, renewals of diminution in value of assets, or retained by way of providing for any known liability or loss of which the amount cannot be determined with substantial accuracy;

(b) The expression "reserve" shall not, subject to as aforesaid, include any amount written or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;

(c) The expression capital reserve shall not include any amount regarded as free for distribution through the profit and loss account; and the expression "revenue reserve" shall mean any reserve other than a capital reserve;

(d) The expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

Where:

(a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or

(b) any amount retained by way of providing for any known liability is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of these accounts as a reserve and not as a provision.

6. The company should make provisions for damages under lawsuits where the management is of the opinion that the award may go against the insurer.

7. Extent of risk retained and reinsured shall be separately disclosed.

8. Any debit balance of Profit and Loss Account shall be shown as deduction from uncommitted reserves and the balance if any, shall be shown separately.

PART IV: CONTENTS OF MANAGEMENT REPORT

There shall be attached to the financial statements, a management report containing, *inter alia*, the following duly authenticated by the management –

1. Confirmation regarding the continued validity of the registration granted by the Authority;

2. Certification that all the dues payable to the statutory authorities have been duly paid;

3. Confirmation to the effect that the shareholding pattern and any transfer of shares during the year are in accordance with the statutory or regulatory requirements;

4. Declaration that the management has not directly orr indirectly invested outside India the funds of the holders of policies issued in India;

5. Confirmation that the required solvency margins have been maintained;

6. Certification to the effect that the values of all the assets have been reviewed on the date of the Balance Sheet and that in his (insurer's) belief the assets set forth in the Balance Sheets are shown in the aggregate at amounts not exceeding their realizable or market value under the several headings – "Loans", "Investments", "Agents balances", "Outstanding Premiums", "Interest, Dividends and Rents Outstanding", "Interest, Dividends and Rents accruing but not due", "Amounts due from other persons or Bodies carrying on insurance business", "Sundry Debtors", "Bills Receivables", "Cash" and the several items specified under "Other Accounts".

7. Disclosures with regard to the overall risk exposure and strategy adopted to mitigate the same;

8. Operations in other countries, if any, with a separate statement giving the management's estimate of country risk and exposure risk and the hedging strategy adopted;

9. Ageing of claims indicating the trends in average claim settlement time during the preceding five years;

10. Certification to the effect as to how the values, as shown in the balance sheet, of the investments and stocks and shares have been arrived at, and how the market value thereof has been ascertained for the purpose of comparison with the values so shown;

11. Review of asset quality and performance of investment in terms of portfolios, i.e., separately in terms of real estate, loans, investments, etc.

12. A responsibility statement indicating therein that:

(i) in the preparation of financial statements, the applicable accounting standards, principles and policies have been followed along with proper explanations relating to material departures, if any;

(ii) the management has adopted accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the operating profit and loss and of the profit or loss of the company for the year;

(iii) the management has taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the applicable provisions of the Insurance Act ,1938 (4 of 1938) / Companies Act, 1956, for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(iv) the management has prepared the financial statements on a going concern basis;

(v) the management has ensured that an internal audit system commensurate with the size and nature of the business exists and is operating effectively.

13. A schedule of payments, which have been made to individuals, firms, companies and organizations in which Directors of the insurer are interested.

PART V: PREPARATION OF FINANCIAL STATEMENTS

1. An insurer shall prepare the Revenue Account, Profit & Loss Account [Shareholders' Account] and the Balance Sheet in Form B-RA, Form B-PL, and Form B-BS, or as near thereto as the circumstances permit.
Provided that an insurer shall prepare Revenue Accounts separately for fire, marine, and miscellaneous insurance business and separate schedules shall be prepared for Marine Cargo, Marine – Other than Marine Cargo and the following classes of miscellaneous insurance and accordingly application of AS 17 – Segment Reporting – shall stand modified.

1. Motor, 2. Workmen's Compensation/Employer's Liability, 3.Public /Product Liability, 4.Engineering, 5.Aviation, 6. Personal Accident, 7.Health Insurance, 8.Others

2. An insurer shall prepare separate Receipts and Payments Account in accordance with the Direct Method prescribed in AS3 – "Cash Flow Statement "issued by the ICAI.

Appointment of Auditors – The appointment of statutory auditors in the General Insurance Corporation of India, and its subsidiaries and the division is made by the Comptroller and Auditor General of India, as in the case of other public sector undertakings. The appointment of auditors of the agencies abroad is made by the Board of Directors of each company.

Rights and duties or Branch Auditors - It is a practice that the divisional offices prepares a trial balance is in a manner that it provide3 information required to be included in the various format of financial statements prescribed in the Insurance Act. Each trial balance, in which are incorporated the figures relating to the branches of the divisions, is required to be audited and the report thereon is furnished to the statutory auditors. The divisions of the companies carrying on general insurance business are treated for the purposes of the Companies Act, 1956 as their branches. It follows that the branch auditor appointed to conduct the audit of the divisions have the same rights and obligations under the statute as those of the, statutory auditors to whom they are expected to submit their report.

Auditor's Report – The Authority has prescribed the matters to be dealt with by the Auditors' Report vide Regulation 3 under Schedule C of IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations,2000. The Schedule C is reproduced below –

The report of the auditors on the financial statements of every insurer shall deal with the specified herein –

1. (a) That they have obtained all the information and explanation which, to the best of their knowledge and belief, were necessary for the purposes of their audit and whether they have found them satisfactory;

(b) Whether proper books of account have been maintained by the insurer so far as appears from an examination of those books;

(c) Whether proper returns, audited or unaudited, from branches and other offices have been received and whether they were adequate for the purpose of their audit;

(d) Whether the Balance Sheet, Revenue Account and Profit & Loss Account dealt with by the report and the Receipts and Payments Account are in agreement with the books of account and returns;

(e) Whether the actuarial valuation of liabilities is duly certified by the appointed actuary, including to the effect that the assumptions for such valuation are in accordance with the guidelines and norms, if any, issued by the authority and/or the Actuarial Society of India in concurrence with the Authority.

2. The auditors shall express their opinion on:

(a) (i) Whether the Balance Sheet gives a true and fair view of the insurer's affairs as at the end of the financial year/period;

(ii) Whether the Revenue Account gives a true and fair view of the surplus or the deficit for the financial year/period;

(iii) Whether the Profit and Loss Account gives a true and fair view of the profit or loss for the financial year/period;

(iv) Whether the Receipts and Payments Account gives a true and fair view of the receipts and payments for the financial year/period;

(b) The financial statements stated at (a) above are prepared in accordance with the requirements of the Insurance Act, 1938 (4 of 1938), the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999) and the Companies Act, 1956 (1 of 1956), to the extent applicable and in the manner so required.

(c) Investments have been valued in accordance with the provisions of the Act and the Regulations.

(d) The accounting policies selected by the insurer are appropriate and are in compliance with the applicable Accounting

Standards and with the accounting principles, as prescribed in these Regulations or any order or direction issued by the Authority in this behalf.

3. The auditors shall further certify that:

(a) they have reviewed the management report and that there is no apparent mistake or material inconsistencies with the financial statements; and

(b) the insurer has complied with the terms and conditions of the registration stipulated by the Authority.

4. A certificate signed by the auditors (which is in addition to any other certificate or report which is required by law to be given with respect to the balance sheet) certifying that:

(a) they have verified the cash balances and the securities relating to the insurer's loans, reversions and life interests (in the case of life insurers) and investments;

(b) the extent, if any, to which they have verified the investments and transactions relating to any trust undertaken by the insurer as trustee; and

(c) no part of the assets of the policyholders' funds has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938 (4 of 1938) relating to the application and investments of the policyholders' funds."

Students may also note that auditors are required to follow the format of report prescribed by the Institute.

Direction of C & AG – The comptroller and Auditor General of India has the power to direct the manner in which the accounts shall be audited and give such instructions in regard to any matter relating to performance of function by the auditor and to conduct the supplementary or test audit of the accounts of such companies by such person or persons as may be authorized in this behalf. For the purpose of such audit the C & AG may require him in terms of Section 619 (4) of the Companies Act, 1956. The statutory auditors are required to submit a copy of their report to the C & AG who has the right to comment upon or supplement the audit report. By virtue of the powers vested in him under Section 619 (3) (a) of the Companies Act, 1956 the C & AG has recently directed that a supplementary report be made by the auditors appointed under Section 619 (2) of the said Act in case of companies carrying on general insurance business. The said report would be on matters listed in the Appendix to this unit of the study.

Tax Audit - It is necessary for general insurance companies to get their accounts audited under Section 44AB of the said Act. For this purpose, the tax auditor(s) may be appointed by the company itself by means of a resolution of the Board of Directors or by the Chairmen/Managing Director if so authorized in this behalf. The company is expected to fix separate remuneration for the auditor (s0 appointed for this purpose. The Form of tax audit report applicable would be Form 3C and the prescribed particulars would have to be given in Form 3CD, in accordance with Rule 3C and the prescribed particulars would have to be given in Form 3CD, in accordance with Rule 6G the Income Tax Rules, 1962, pursuant to Section 44AB of the Income Tax Act, 1961. It is recommended that wherever applicable, a common audit programme be framed for statutory audit and for certification of the prescribed particulars under the aforesaid rules for tax audit.

Applicability of CARO, 2003 – As per Section 1(2) Companies (Auditor's Report) Order, 2003, (as amended in November 2004) the provisions of CARO are not applicable to insurance companies.

Audit of Revenue Account: The important part of the business operations of general insurance companies comprises the issuance of policies for risks assumed and to indemnify the insured for losses to the extent covered by such policies. In financial terms, these operations get translated into the receipt and recording of premiums and the recording and settlement of claims. Both premiums and claims have a significant impact on the insurance companies' revenues, it would be an important part of the duty of the auditor to satisfy himself that the financial transactions involving both these operations have been fairly and properly recorded in the relevant books of account. The auditor should also ensure that the legal requirements as to the disclosure of these items are complied within the financial statements.

Premium - Insurance premium is collected upon issuing policies. It is the consideration for bearing the risk by the insurance company. The assumption of the risk starts on the issue of receipt based on the acceptance of proposal form or cover note by the respective underwriting de3partent. This receipt is recorded as the premium income in the books of the insurance company. Premium may be accepted either in cash/cheque/Demand Draft/pay order, bank guarantee, cash deposit, etc. The premium collections are credited to a separate bank account and no withdrawals are normally permitted from that account for meeting the general expenditure. As per the policy of the insurance company, the collections are transferred to the Regional Office or Head Office. As soon as the insurance policy is issued, an entry is made in the Register of Policies showing all the relevant details.

No Risk Assumption without Premium - No risk can be assumed by the insurer unless the premium is received. According to Section 64 VB of the Insurance Act, 1938, no insurer should assume any risk in India in respect of any insurance business on which premium is ordinarily payable in India unless and until the premium payable is received or is guaranteed to be paid by such person in such manner and within such time, as may be prescribed manner. The premium receipt of insurance companies carrying on general insurance business normally arise out of three sources, viz., premium received from direct business, premium received from reinsurance business and the share of co-insurance premium.

Verification of Premiums – Verification of premium is of utmost importance to an auditor. The auditor should apply, inter alia, the following procedures for verification of premium.-

Before commencing verification of premium income, the auditor should look into the internal controls and compliance thereof as laid down for collection and recording of the premiums.

The auditor should ascertain that all the cover notes relating to the risks assumed have been serially numbered for each class of business. The auditor should also verify that there is an adequate internal check on the issues of stationery comprising of cover notes, policy documents, stamps, etc. The auditor may apply sampling techniques for verification of larger volume of transactions.

The auditor should ensure that premium in respect of risks incepting during the relevant accounting year has been accounted as premium income of that year on the basis of premium revenue recognition discussed in this Chapter. The auditor, as part of his audit procedures, should make an assessment of the reasonability of the risk pattern established by the management. The auditor should also see whether the premium received during the year but pertaining to risk commencing in the following year has been accounted for under the head ‘Pertaining to risk commencing in the following year has been accounted for under the head ‘Premium Received in Advance’ and has been disclosed separately. Normally, such instances relate to the issue of cover notes and certificates at the end of the accounting year relating to risks commencing in the next accounting period. Generally, there is a column in the Premium Register called “Commencement of Risk”, indicating the date and time from which the risk under the policy issued has commenced. The auditor should verify that policy documents have not been issued, or where issued, the company was not at risk, in case :

a) Premium had not been collected at all;

b) Premium had been collected but the relevant cheque have been dishonoured; (refer Cheque Dishonoured Book);

c) premium had not immediately been collected due to furnishing of a bank guarantee or cash deposit but either the deposit or guarantee had fallen short or has expired or the premium had been collected beyond the stipulated time limit (i.e., there is a shortfall in bank guarantee account or cash deposit account of the insured);

d) premium had not been collected due to risk cover being increased or where stipulated limits have been exhausted in respect of open declaration policies (i.e., where premium has accrued but has not been received); and installments of premium have not been collected in time in respect of certain categories of policies. e.g. marine-cum-erection policies where facility has been granted for premium being paid in installments (such facility is normally available subject to certain conditions, e.g. that the first equated installments is more by 5 per cent of the total premium payable by installments).

The auditor should examine whether the reinsurance company is not under a risk in respect of amount lying at credit and outstanding as at the year-end in the following accounts:

a) Deposit Premium Account;

b) Premium Received in Advance Account;

c) Inspectors' Deposits Account; and

d) Agent's Premium Accounts

The auditor should verify the collections lodged by agents after the balance sheet date to see whether any collection pertains to risk commencing for the year under audit. The auditor should also check that the premium has been recorded originally at the gross figure. i.e. without providing of unexpired risks and reinsurances.

In case of co-insurance business, where the company is not the leader, because of the non-availability of the relevant information in many cases the premium is not booked even though the risk has commenced during the relevant accounting year. The auditor should see that the company's share of the premium has been accounted for on the basis of the available information on nature of risk and the provisional premium charged by the leading insurer. The auditor should examine the communications issued to the company by the leading insurers advising them of the company's share of premium income. Such communications should be seen even in respect of the post-audit period. Where the company is the leader, the auditor should obtain a responsible assurance that only the company's own share of premium has been shown as income and accounts of the other companies have been credited with their share of the premium collected.

The auditor should check whether Premium Registers have been maintained chronologically, for each underwriting department, giving full particulars including service tax charged as per acceptance advice on a day-to-day basis. The auditor should verify whether the figures of premium mentioned in the register tally with those in General Ledger.

Where policies have been issued with a provision to collect premium periodically (i.e., under installment clause, special declaration policy or periodical declaration under open policies in marine insurance), the auditor should check whether premium are collected as and when they become due.

The auditor should verify whether installments falling due on or before the balance sheet date, whether received or not, have been accounted for as premium income as for the year under audit. Also examine whether installments of premium falling due in the subsequent year have not been recognized in the accounts as outstanding premium.

The auditor should verify the year and transactions to check that amounts received during the year in respect of risks commencing/installments falling due on or after the first day of next financial year are not credited to premium account but credited to Premium Received in Advance Account.

The auditor should verify the collections remitted by agents immediately after the cut-off date to verify the risk assumed during the year under audit on those collections.

The auditor should also check that in case of cancellation of policies / cover notes issued, no risk has been assumed between the date of issue and subsequent cancellation thereof.

Where premium originally received has been refunded, the auditor should verify whether the agency commission paid on such premium has been recovered.

The auditor should verify whether service tax has been charged from the insured, the rates in force, on the total premium for all classes of business other than those exempted under service tax laws. Check whether service tax so collected is disclosed under ‘Current Liabilities’ to the extent not deposited in Government’s Account.

In the case of co-insurance business, the auditor should verify whether service tax at the rates in force on the whole premium has been charged or collected form the insured by the company in case it is the leader.

Check that service tax so collected on premium charged trained from the insured by the company have been regularly deposited in the Government's Account.

Claims- The components of the cost of claims to an insurer comprise the claims under policies and claim settlement costs. Claims under policies comprise the claims paid for losses incurred, and those estimated or anticipated claims pending settlements under the policies. Settlement cost of claims includes surveyor fee. Legal expenses. etc. A liability for outstanding claims should be brought to account on the following:

- Direct Business;
- Inward Reinsurance Business; and
- Co-Insurance business

The liability includes future payments in relation to unpaid reported claims and claims incurred but not reported including inadequate reserves which would result in future cash or asset outgo for setting liabilities against those claims. Change in estimated liability represents the difference between the estimated liabilities for outstanding claims in respect of claims under policies, whether due or intimated at the beginning and at the end of the financial period. The accounting estimate also includes claims cost adjusted for salvage value if there is sufficient degree of certainty of its realization.

Check that service tax so collected on premium charged trained from the insured by the company have been regularly deposited in the Government's Account.

Registers and Records : The following register and records are generally prepared in respect of claims:

- Claims Intimation Register,
- Claims Paid Register,
- Claims Disbursement Bank Book;
- Claims Dockets, normally containing the following records:
- Claim intimation, claim form, particulars of policy, survey report, Photograph showing damage, repairer's bills, letter of subrogation, police report, fire service report, claim settlement note, claim satisfaction note, salvage report, salvage disposal note, claims discharge voucher, etc.;
- Report of quality assurance team; and
- Salvage register

The Claim Account is debited with all the payments including repair charges, fire fighting expenses, police report fees, survey fees, amount decreed by the Courts, travel expenses, photograph charges, etc. The provision for claims incurred but not reported is not made at Branch/Divisional Office level but at the Head Office level.

Verification of Claims

Claims Provisions : The auditor should obtain from the divisions/branches, the information for each class of business, categorizing the claims value-wise before commencing verification of the claims provisions, so that appropriate statistical sampling techniques may be applied, to ensure that representative volume of claims is verified for each class of business. The auditor should determine the total number of documents to be checked giving due importance to claim provisions of higher value.

The outstanding liability at the year-end is determined at the divisions/branches where the liability originates for outstanding claims. Thereafter, based on the total consolidated figure for all the divisions/branches, the Head Office considers a further provision in respect of outstanding claims. The auditor should satisfy himself that the estimated liability provided for by the management is adequate with reference to the relevant claim files/dockets, keeping in view the following:

(i) that provision has been made for all unsettled claims as at the year-end on the basis of claims lodged/communicated by the parties against the company. The date of loss (and not the date of communication thereof) is important for recording/recognizing the claim as attributable to a particular year. In certain circumstances, the claims are incurred by the insurance company but are not reported at the balance sheet date by the insured. Such claims are known as claims incurred but not reported (IBNR). The auditor should check the records for subsequent periods to ascertain that adequate provision has been created for such claims also.

(ii) that provision has been made for only such claims for which the company is legally liable, considering particularly, (a) that the risk was covered by the policy, if in force, and the claims arose during the currency of the policy; and (b) that claim did not arise during the period the company was not supposed to cover the risk, e.g.; where the premium was not paid or where cheques covering premium have been dishonoured (refer section 64 VB of the Insurance Act. 1938) or where a total loss under a policy has already been met/settled.

(iii) that the provision made is normally not in excess of the amount insured except in some categories of claims where matter may be sub-judice in legal proceeding s which will determine the quantum of claim, the amount of provision should also include survey fee and other direct expenses.

(iv) that in determining the amount of provision, events after the balance sheet date have been considered. e.g., (a) claims settled for a materially higher/lower amount in the post-audit period; (b) claims paid by other insurance companies during the year under audit and communicated to company after the balance sheet date where other companies are the leaders in co-insurance arrangements; and (c) further reports by surveyors or assessors.

(v) that the claims status reports recommended to be prepared by the Divisional Manager on large claims outstanding at the year-end have been reviewed with the contents of relevant files or dockets for determining excess/short provisions. The said report should be complete as to material facts to enable the auditor to take a fair view of the provision made.

(vi) that in determining the amount of provision, the average clause; has been applied in case of under-insurance by parties.

(vii) that provision made is net of payments made ‘on account’ to the parties wherever such payments have been booked to claims.

(viii) that in case of co-insurance arrangements, the company has made provisions only in respect of its own share of anticipated liability.

(ix) that wherever an unduly long time has elapsed after the filing of the claim and there has been no further communication and no litigation or arbitration dispute is involved, the reasons for carrying the provision have been ascertained.

(x) that wherever legal advice has been sought or the claim is under litigation, the provisions is made according to the legal advisor’s view and differences, if any, are explained.

(xi) that in the case of amounts purely in the nature of deposits with courts or other authorities, adequate provision is made and deposits are stated separately as assets and provisions are not made net of such deposits.

(xii) that no contingent liability is carried in respect of any claim intimated in respect of policies issued.

(xiii) that the claims are provided for net of estimated salvage, wherever applicable.

(xiv) that intimation of loss is received within a reasonable time and reasons for undue delay in intimation are looked into.

(xv) that provisions have been retained as at the year end in respect of guarantees given by company to various Courts for claims under litigation.

(xvi) that due provision has been made in respect of claims lodged at any office of the company other than the one from where the policy was taken, e.g. a vehicle insured at Mumbai having met with an accident at Chennai necessitating claim intimation at one of the offices of the company at Chennai.

In cases of material differences in the liability estimated by the management and that which ought to be provided in the opinion of the auditor, the same must be brought out in the auditor's report after obtaining further information or explanation from the management. For determining the adequacy of the provisions in respect of any category of business, the auditor may resort to the method of testing the actual payments, wherever made, with the provisions made earlier for that category of business. Whether such liability has been estimated in the past on a fair and realistic basis can, thus, be examined by looking into current yea's payments against provisions of the earlier year.

Claims Paid – The auditor may determine the extent of checking of claims paid on the same line as suggested for outstanding claims. Other aspects in respect of claims paid to be examined by the auditors are as follows:

(i) that in case of co-insurance arrangements, claims paid have been booked only in respect of company's share and the balance has been debited to other insurance companies.

(ii) That in case of claims paid on the basis of advices from other insurance companies (where the company is not the leader in co-insurance arrangements), whether share of premium was also received by the company. Such claims which have been communicated after the year-end for losses which occurred prior to the year end must be accounted for in the year of audit.

(iii) That the claims payments have been duly sanctioned by the authority concerned and the payments of the amounts are duly acknowledged by the claimants;

(iv) That the salvage recovered has been duly accounted for in accordance with the procedure applicable to the company and a letter of subrogation has been obtained in accordance with the laid down procedure;

(v) That the amounts of the nature of pure advances/deposits with Courts, etc., in matters under litigation/arbitration have not been treated as claims paid but are held as assets till final disposal of such claims. In such cases, full provision should be made for outstanding claims;

(vi) That payment made against claims partially settled have been duly vouched. In such cases, the sanctioning authority should be the same as the one which has powers in respect of the total claimed amount;

(vii) That in case for final settlement of claims, the claimant has given an unqualified discharge note, not involving the company in any further liability in respect of the claim; and

(viii) That the figures of claims wherever communicated for the year by the Division to the Head Office for purposes of reinsurance claims, have been reconciled with the trial balance-figure.

Commission – It is a well-known fact that insurance business is solicited by insurance agents. The remuneration of an agent is paid by way of commission which is calculated by applying a percentage to the premium collected by him. Commission is payable to the agents for the business procured through them and is debited to Commission on Direct Business Account. There is a separate head for commission on reinsurance accepted which usually arise in case of Head Office. If may be noted that section 40 of Insurance Act, 1938, no commission can be paid to a person who is not an agent of the insurance company.

The auditor should, *inter alia,* do the following for verification commission:

- Vouch disbursement entries with reference to the disbursement vouchers with copies of commission bills and commission statements.
- Check whether the vouchers are authorized by the officers-in-charge as per rules in force and income tax is deducted at source, as applicable.
- Test check correctness of amounts of commission allowed.
- Scrutinize agents' ledger and the balances, examine accounts having debit balances, if any, and obtain information on the same. Necessary rectification of accounts and other remedial actions have to be considered.
- Check whether commission outgo for the period under audit been duly accounted.

Operating Expenses Related to Insurance Business (Expenses of Management) – All the administrative expenses in an insurance company are broadly classified under 13 heads as mentioned in

Schedule 4. In so far as financial statements are concerned, this Schedule is part of the Revenue Account to be prepared for insurance business. Any other expenses are required to be disclosed under the head ‘Others’. ‘Others’ would include foreign exchange gains or losses as indicated in note ‘b’ of Schedule 4. Any major expenses (Rs. 5 lacs or in excess of 1% of net premium, whichever is higher) are required to be shown separately. Careful reading of the words ‘expenses related to insurance business’ clearly indicate any expenses which do not have any direct relation to insurance business are to be shown separately in the Profit and Loss Account. Expenses relating to investment department, brokerage, bank charges, transfer fees, etc. do not have a direct relationship to the day-to-day working of the insurance business and as such would not be included in the revenue account.

These expenses are first aggregated and then apportioned to the Revenue Account of each class of business on a reasonable and equitable basis. The accounting policy should clearly indicate the basis of apportionment of these expenses to the respective Revenue Accounts (i.e. fire, marine and miscellaneous) along with the certificate that all expenses of management, wherever incurred, directly or indirectly, read with the accounting policy, have been fully debited to the respective Revenue Account as expenses. Refer to Schedule 4 on Operating Expenses for specific items.

Legal and Professional Charges- As far as legal and professional changes are concerned, attention is drawn to the head ‘Claims Incurred’ under Schedule 2 where it is clearly stated that survey fees, legal and other expenses should form part of claim cost, and therefore, are not to be included under the head Legal and Professional Charges. Hence, all other expenses which are not covered under the claims cost are required to be included under this head.

Employees’ Remuneration and Welfare Benefits – The employees’ remuneration includes all kinds of payments made to employees in consideration of their services. The reimbursement of medical expenses or premium in respect of employees’ health cover is covered under the employees’ remuneration and welfare. Any medical fees incurred towards maintenance of health care policies (which are not for employees) are required to be debited to the claims cost under the health care and not to be included under this head. Any expenses toward medical treatment of employees incurred by the company should also be included under this head. Non training expenses have to be shown separately.

Interest and Bank Charges- All expenses incurred towards maintenance of Bank Account, interest and other charges levied by bankers to the normal course of business other than bank expenses relating to investments (interest, bank charges, custodial charges, etc.) are shown under the head, “interests and bank charges”. Any other interest charged on the borrowings which could not form part f the Revenue Account not be included under this head.

Depreciation- The rates of depreciation are governed by the provisions of the Companies Act, 1956. Attention of the students is also invited to Accounting Standard (AS) 6, Depreciation Accounting, and Guidance Note on, Depreciation in Companies, issued by the Institute of Chartered Accountants of India.

Interest, Dividend and Rent- An insurance enterprise, like any other earns interest dividend and rent through its assets. The interest, dividend and rent earned are to be apportioned between Revenue Account and Profit and Loss Account. The regulations require that basic of allocation of interest, dividend and rent between the Revenue Account and Profit and Loss Account should be clearly indicated in the company’s accounting policy. The interest or dividend earned as against the policyholder’ funds is required to be apportioned to the Revenue Account. The interest earned on, say, grant of vehicle loans, housing loans, deposits with banks of the shareholders, funds, rent received on let out properties owned by the company, by way of investments shareholders, funds, etc. are required to be shown under the profit and loss account.

ITEMS RELATING TO BALANCE SHEET

Following are the broad classes of items in a balance sheet.

Investments – The legal requirements for investments by enterprises carrying on general insurance business are provided under sections 27B, 27C and 27D of the Insurance Act, 1938. Sub-section (1) of section 27B lays down that no insurer carrying on general insurance business can invest or keep invested any part of its assets otherwise than in any of the approved investments mentioned in the section. Sub-Section (3), however, gives a leverage to an insurer to invest or keep invested any part of its assets otherwise than in an approved investment if the following conditions are satisfied:

(a) such investments should not exceed 25% of the total investments; and
(b) such investments are made with the consent of all the Directors.

The consent of Directors appointed under section 34C of the Insurance Act, 1938 is not necessary. However, such Directors should not object to the investments so made or continued.

Sub-section (4) of section 27B requires that an insurer should not invest or keep invested any part of its assets of any one insurance company or an investment company which constitutes more than then ten percent of the total assets of the insurer or two percent of the subscribed share capital or debentures of the insurance companies or investment company concerned. Similar considerations also apply to the investment in shares or debenture of any other company not being an insurance companies or investment company. In such cases, the limit of two percent of the subscribed share capital or debentures of the insurance companying company or the investment company concerned is to be read as ten percent {sub-section(5)}. According to sub-section (6), an insurer cannot invest in the shares or debentures of a private company. It may noted that in case an investments has been made in the partly paid up shares of a company, the uncalled liability on the shares is to be added to the amount invested for the purpose of computing the percentages referred to above.

The authority has been authorized to frame regulations related to investments to be made by an insurer. Regulations 4 of the amended Regulations on investments prescribes that every insurer carrying on the business of general insurance should invest and at all time keep invested its total assets in the following manner:

(i)	20 percent for more of total assets	Central Government Securities
(ii)	30 percent or more of total assets	State Government Securities and other Guaranteed Securities [including (i) above]
(iii)	5 percent or more of total assets	Housing and Loans to State Government for Housing and Fire Fighting Equipment
(iv)	10 percent or more of total assets	Investment in approved securities (as specified in Schedule 11 to the Regulations) under infrastructure and social sector
(v)	Up to 55 percent of total assets	Other securities (covered by Exposure Norms specified in Regulation 5). It may be noted that investments in “other than approved securities” can in no case exceed 25 percent o the total assets.

It may be mentioned here that with regard to (iv) above, subscription/purchase of bonds or debentures issued by HUDCO, National Housing Insurance Company or House Building Institutions duly accredited by National Housing Banks, for house building activities, duly guaranteed by Government or carrying current fating of not less than 'AA' by an independent, reputed and recognized agencies also qualify to be included in the limits [under clause (iv)] above.

Audit Procedures: The auditor's primary objective in audit of investment is to satisfy himself as to their existence and valuation. Examination of compliance with statutory and regulatory requirements it also an important objective in audit of investments in so far as non-compliance may have a direct and material affect on the financial statements.

The auditor should verify the investment scrips physically at the close of business on the date the balance sheet. In exceptional cases where physical verification of investment scrips on the balance sheet date is not possible, the auditor should carry out the physical verification on a data as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc. he should take particular care to see that only genuine investments are produced before him, and that securities held by the insurance company on behalf of others (e.g. those held as security this, the auditor should –require that all investment scrips in the possession of the insurance simultaneously. The auditor should keep them under his control until he completes his checking. Normally, the investments of an insurance company are held by the insurance company itself or a depository (in case of dematerialized securities other than government securities).

Investments are normally dealt with at the Head Office and not at the branches. However, sometimes, for realization of interest, etc. and other similar purposes, investments of an insurance company may be held at Branch Offices also. In such cases, the auditor should examine the record maintained at the Head Office to record details of investments held at other locations and request the respective branch auditors to physically verify such investments as apart of their audit. The auditors should obtain a written confirmation to this effect from the branch auditors. in case the verification has been done on the date other than the balance sheet date, a statement showing the reconciliation of the investments held at the time of physical verification with the investments held as on the balance sheet date should also be obtained from the branch auditors. The branch auditors should report whether adequate records are maintained by the branch for the securities held by it on behalf of the Head Office.

Investments should not normally be held by any other person (as laid down in the City Equitable Fire Insurance Co. case). If any investments are so held, proper enquiry should be made to ensure that there is some justification for it, e.g., shares may be held by brokers for the purpose of transfer or splitting-up, etc. Shares may also be lodged with the companies concerned for transfer etc. When investments are held by any other person on behalf of the insurance company, the auditor should obtain a certificate from him. The certificate should state the reason for holding the investment (e.g., in safe custody or as security).

In respect of scripless dealings in investments through the OTC Exchange of India, the auditor should verify the interim and other acknowledgments issued by dealers as well as the year end confirmation certificates of the depository organization.

The auditor should also examine whether securities lodged for transfer are received back within a reasonable period. Similarly, he should examine whether share certificates, etc. are received within a reasonable period, of the lodging of the allotment advice. Incase there is an unusual delay in registration of transfers, etc., the auditor should see that adequate follow-up action has been taken. He may, in appropriate cases, also enquire from the issuers, or their registrars, about the delays. In cases where the issuer/registrar has refused to register the transfer of securities in the name of the insurance company, the auditor should verify the validity of the title of the insurance company over such securities.

The auditor should examine whether the portfolio of the insurance company consists of any securities whose maturity dates have already expired. It is possible that income on such investments may also not have been received. In case the amount of such investments or the income accrued thereon is material, the auditor should seek an explanation from the management on this aspect. He should also consider whether any provision for loss on this account is required. Similarly, where income on any security is long overdue, the auditor should consider whether provision is required in respect of such income accrued earlier.

Investments in securities now-a-days constitute a substantial part of total assets of many insurance companies. Method of valuation of investments followed by an insurance company may, therefore, have a significant effect on its Balance Sheet and Profit and Loss Account. The auditor should examine whether the method of accounting followed by the insurance company in respect of investments, including their year-end valuation, is appropriate.

The auditor should examine the manner of accounting for investments and the accounting policy followed by the insurance company in respect of investments. The audit of should examine the appropriateness of accounting policies followed by the insurance company. In case of any of the accounting policies is not appropriate, the auditor should consider the effect of adoption of such policy on the financial statements and, consequently, on his audit report.

A change in the method of valuation of investments constitutes a change in accounting policy and adequate disclosure regarding the fact of the change along with its financial effect should be made in the balance sheet.

The auditor should examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the insurance company has opted for receipt of income through the Electronic Clearing Service.

There may be case where the certificates of tax deduction at source (TDS) received along with the interest on investments are found missing. This increases the incidence of tax on the insurance company. The auditor should see that there is a proper system for recording and maintenance of TDS certificates received by the insurance company.

Cash and Bank Balances- Cash and Bank balances at Branch Office/Divisional Office level also constitute significant items related to balance sheet. The auditor should apply the following audit procedures for verification of claims.

- The auditor should physically verify cash balance collection and imprest for meeting day to day expenditures, postage stamps balance, revenue, policy, license fees, franking machine balance. The auditor should also obtain a certificate from the management for the above mentioned balances as at the balance sheet date. If for some reason, the physical verification of the above on the balance sheet date is not possible then the same can be done at a subsequent date and by way of backward calculations, cash in hand at the balance sheet date can be verified.
- The auditor should also check whether late collections of cash and cheques on the last working day of the financial year, which could not be deposited into bank account on the same day, have been identified and booked as Cash in Hand and Cheques in Hand Account, respectively.
- The auditor may apply test check on the bank transactions.
- The auditor should also check Bank Reconciliation statement and long outstanding entries therein.

- The auditor should obtain confirmation of Bank Balances for all operative and inoperative accounts.
- The auditor should physically verify Term Deposit Receipts issued by bankers.
- The auditor should verify the deposits and withdrawals transactions at random and check whether the Account is operated by authorized persons only.
- The auditor should verify the subsequent realizations for all items appearing in the reconciliation.
- In case of funds, in-transit, he should verify that the same are properly reflected as part of bank balance.

Outstanding Premium and Agents' Balances – The following are the audit procedures to be followed for verification of outstanding premium and agents' balances:

- Scrutinize and review control account debit balance and their nature should be enquired into.
- Examine inoperative balances and treatment given for old balances with reference to company rules.
- Enquire into the reasons for retaining the old balances.
- Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.
- Check age-wise, sector-wise analysis of outstanding premium.
- Verify whether outstanding premiums have since been collected.
- Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

Provision for Taxation – The steps to be conducted by the audit for audit and verification are given below:

(i) The auditor should check whether the provision for taxation has been made after taking into account the above specific provisions applicable to insurance companies carrying on general insurance business.

(ii) It should be seen by auditor whether for the purpose of computation not only the profit as disclosed by the annual accounts, copies of which are required under the Insurance Act, 1938 to be furnished to the Controller of Insurance, is taken but also all the other accounts furnished by the company to the Controller of Insurance is taken into account.

(iii) The auditor should assess the past trend regarding the approach of the Income Tax Department, the decision of the various appellate forums including the High Court and the Supreme Court vis-à-vis the computation made.

(iv) The compliance with the provisions of Chapter III provisions the Income Tax Act, 1961 which provides for income which do not form part of total income is also to be seen.

(v) The auditor should see whether deductions under Chapter VI A of the Income Tax Act, 1961 which provides for deduction have been made in computing total income is properly taken into account.

(vi) The auditor should examine whether income computation relating to foreign branches and other income earned outside India is dealt with properly as per the double taxation avoidance agreement, if any, entered into with those countries.

(vii) It should be seen whether the exemption provision relating to tax deducted at source from certain categories of income as exempted under section 35A of the General Insurance (Business Nationalization) Act, 1972 has been properly availed.

(viii) Also, the auditor should check whether the grossing up of TDS relating to the income has been properly done for the propose of computation of taxable income.

(ix) The auditor should ensure that the provisions of the Income Tax Act, 1961 regarding the tax to be deducted at source have been properly complied with, relating to the payments/credits for which the TDS provisions of the Income Tax Act and applicable and the amount so deducted are remitted within the stipulated time. Also check TDS implication on the interest paid/payable and included on claim settlement/outstanding claims.

(x) The auditor may also assess the applicability of the Wealth Tax Act, 1957 with reference to the assets of the company at the end of the year.

(xi) The auditor should see the system of service tax collection and the payment to the statutory authorities and the internal system including the filing of the statutory returns.

(xii) The examination of sales tax implication on the sale of salvage should also be seen as it is applicable to the respective states and the past trend in this regard.

(xiii) The auditor should check the liability under the VAT and whether provision for adequate amount has been made in the books or not.

(xiv) The auditor should verify that adequate provision been made for additional liability relating to earlier years for which demands have been received in the current year and where the company has gone into appeal, the fact that no provision has been made and that an appeal has been preferred has to be disclosed in the notes to accounts.

Unexpired Risks Reserve – The need for Unexpired Risks Reserve arises from the fact that all policies are renewed annually except in specific cases here short period policies are issued. Since the insurers close their accounts on a particular date, not all risks under polices expire on that date. Many policies which may occur during the remaining term of the policy beyond the year end. The effort involved in calculating unexpired portion of premium under each policy is very time consuming therefore, a simple formula to derive a percentage of premium income to be allocated to reserve for unexpired risks is adopted. According to the requirements of the Insurance Act, 1938, for the purpose of maintaining solvency margin, it is sufficient if the provision is made for unexpired risks at 50 percent for Fire, Marine Cargo and Miscellaneous business except for Marine Hull which has to be 100 percent. It ma be mentioned that the insurance companies are governed by the provisions of Section 44 of the Income Tax Act, 1961. In this regard Rule 5 of the First Schedule to the Income Tax Rules-Computation of Profit & Loss of General Insurance Business-provides for creation of a reserve for unexpired risks as prescribed under Rule 6E of the said rules. According to this Rule, the insurance companies are allowed a deduction of 50 percent of net premium income in respect of Fire and Miscellaneous Business and 100 percent of the net premium income relating to Marine Insurance business. In view of this, the reserves are created at the rates allowed under the Income Tax Act.

REINSURANCE

A reinsurance transaction may be defined as an agreement between a ‘ceding company and a ‘reinsurer’ whereby the former agrees to ‘cede’ and the latter agrees to accept a certain specified share of risk or liability upon terms as set out in the agreement. A ‘ceding company’ is the original insurance company which has accept the risk and has agreed to ‘cede’ or pass on that risk to another insurance company or the reinsurance company. It may, however, be emphasized that the insured does not acquire any right under a reinsurance contract. In the event of loss, the insured’s claim for full amount is against the original insurer only. The original insurer in turn, lodges a claim with the reinsurer.

Verification of Re-Insurance Inward – Under Sub-regulation 4 of the IRDA (General Insurance Reinsurance) Regulations, 2000 every insurer desirous of writing inward reinsurance business should have a well defined underwriting policy. The decisions on acceptance of re-insurance should be taken by persons with good knowledge and experience, with the Authority, a note the following verifications measures for re-insurance inward transactions:

- Re-insurance inward underwriting should be as per the norms and guidelines prescribed by the Insurance Act, 1938 and IRDA Regulations. It is necessary to ensure that the inward reinsurance arrangements and acceptances, both Indian and foreign are done as per the prescribed parameters applicable for the particular year.
- The auditor should check that domestic inward acceptances are in accordance with the approved programme.
- The auditor should verify whether re-insurance inward acceptance, both Indian and foreign, are as per arrangements/agreements entered into with Indian and foreign insurance companies.
- The auditor should also verify whether the policy adopted for booking the accounts is on "receipt" basis or "due" basis with the appropriate basis of estimation towards accounts not received and that the basis of estimation is fair and consistently applied and properly disclosed.
- The auditor should examine whether proper system exists to have control over the quantum of agreements existing at any point of time and also that periodical accounting statements received in connection with the agreements.
- The auditor should verify whether proper closing returns have been received for premiums and claims for facultative acceptances.
- The auditor should check the accounts for closure of any underwriting year, with portfolio withdrawals as per the terms and conditions agreed.
- The auditor should evaluate the system and practice adopted in recognizing the foreign currency transaction and also whether it is in accordance with the Accounting Standard (AS)-11, Accounting for Effects of Changes in Foreign Exchanges Rates.
- The auditor should verify whether profit commission has been calculated as per the agreement and terms and conditions and all the statements rendered are properly taken into account.
- The auditor should check whether there is any run off claim/large claim of long chain in nature which requires any provisioning.
- The auditor should also verify whether the Foreign Inward acceptance components, consisting of premium, commission, brokerage and other expenses, claims consisting of paid claims opening and closing outstanding claims etc., have been recorded and accounted as per the accounts rendered by the

companies. It is essential that the statement should be rendered in the currency in which it was agreed to be transacted and the conversion of foreign currency balances from the accounts submitted have been done at the appropriate conversion rates as per Accounting Standard (AS)-11.

- The auditor should examine whether the outstanding claim figures have been properly obtained well in time, under proper systematic arrangements and sufficient provisioning has been made for all the outstanding claims. The auditor should see that regarding foreign inward, appropriate provisioning is none after adopting prescribed conversion rate to the India rupee. The auditor should ensure that confirmation regarding the outstanding claims have been received in respect of all inward arrangements.
- As per IRDA (General Insurance-Reinsurance) Regulations,2000 every insurer is required to make provision for outstanding claims for all reinsurance arrangements accepted on the basis of loss information advices received from brokers/cedants and where such advices have not been received, on an actuarial estimation basis. In addition, every insurer has to make an appropriate provision for 'Incurred but Not Reported (IBNR)' claims on its reinsurance accepted portfolio on actuarial estimation basis. This aspect has to be looked into as this may result in a lot of difference in the financial results of the company.
- Closing balances of the re-insurer's accounts should be reconciled and the confirmation of balances should be obtained from all the companies.
- The auditor must ensure that foreign inward accounts balances have been re-stated at the prevailing value at the year end and that difference arising out of re-statement has been taken to Profit and Loss Account.
- The auditor should verify the requirement of provision/write off of reinsurance inward balances based o the doubtful nature of recovery, if any.
- The auditor should check whether Indian inward balances including with the GIC have reconciled and identical balances arrived at and affect, if any, due co-insurance transactions should also be looked into.

Verification of Re-Insurance Outward – The following steps may be taken by the auditor in the verification of re-insurance outward:

- The auditor should verify that re-insurance underwriting returns received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.

- The auditor should check whether the pattern of re-insurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.
- The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.
- The auditor should verify whether the cessions have been made as per the agreements entered into with various companies.
- It should also be seen whether the outward remittances to foreign re-insurers have been done as per the foreign exchange regulations.
- It should also be seen whether the commission on cession has been calculated as per the terms of the agreements with the re-insurers.
- The auditor should verify the computation of profit commission for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.
- The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.
- The auditor should also verify whether the Claims Paid item appears in Outstanding Claims list by error. This can be verified at least in respect of major claims.
- He should see whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.
- Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.
- The auditor should check percentage pattern of gross to net premium, claims paid and outstanding claims to ensure comparative justification.
- The auditor should also check that the re-insurers balance on cessions and whether the sub ledger4 balances tallies with the general ledger balances.
- The auditor should review the individual accounts to find out whether any balance requires provisioning/write back.
- He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.

- He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.
- He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims vis-à-vis the reinsurance inwards outstanding losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analyzed.
- Any major event after the Balance Sheet date which might have wider impart with reference to subsequent changes regarding the claim recovery both paid and outstanding and also ore-insurance balances will need to be brought out suitably.

CO-INSURANCE

Where the insured chooses to have more than one insurer for the same transaction of risk, it would amount to coinsurance.

The auditors should get information from the agreement arrived at the Insurance Council, where the insurance companies may chose to be the members. (Whether the concept of Insurance Council is in place). Members of the Insurance Council could arrive the mutually agreeable terms and norms of entering into coinsurance agreement and the norms for settlement of dues. The Insurance Council may recommend the following norms while entering into coinsurance agreement:

- Settlement of commission
- Collection and Remittance of service tax
- Standard practices for settlement of dues
- Settlement of claims
- Reinsurance arrangement for the risk booked
- Exceptional booking and the powers thereof deviating from the Council's understanding.

The auditor should go through the understanding of the Council and ensure that the risks are covered as per the terms and conditions with adequate consideration and proper settlement.

SOLVENCY MARGIN

Section 64A of the Insurance Act, 1938, inter alia, requires every insurer to maintain an excess of the value of its assets over the amount of its liabilities at all times. The excess is known as 'Solvency Margin'. In the case of insurer carrying on general insurance business, the solvency margin should be the highest of the following amounts;

(a) fifty crore rupees (one hundred crores of rupees in case of a reinsurer); or
(b) a sum equivalent to twenty percent of net premium income; of
(c) a sum equivalent to thirty percent of net incurred claims,

Subject to credit for reinsurance in computing net premiums and net incurred claims being actual but a percentage determined by the regulation but not exceeding fifty percent. It may be noted that conditions regarding maintenance of the above mentioned solvency margin may be relaxed by the Authority in certain special circumstances.

Maintenance of solvency margin has a great importance for an insurance company considering their size and nature of business and also involvement of public money. Sub-section (2C) of Section 64A states that if an insurer fails to comply with the requirements of the Insurance Act, 1938, it shall deemed to be insolvent and may be wound up by the Court.

IRDA Regulations – Sub section (3) of Section 64V of the Act requires that every insurer should value the assets and liabilities in the manner laid down by the Section 64V and in accordance with the regulations which may be made by the Authority in this behalf.

Every Insurer is required prepare a statement of value of assets in “Form IRDA-Assets-AA”. A statement of the amount of liabilities in case of general insurance business is to be prepared in “Form HG” and a statement of Solvency Margin in “Form KG” as specified in the Insurance Regulatory and Development Authority (Assets, Liabilities and Solvency Margin of Insurers) Regulations. The statement of assets, liabilities and solvency margin are to be certified by an auditor and filed by the insurance company with the Authority within six months from the end of the period to which they refer to along with the audited accounts and statements. The salient features pertaining to the valuation of assets are discussed below:

Statement of Solvency Margin – Every insurer is required to determine the required solvency margin, the available solvency margin and the solvency ratio in the Form KG. The statement of solvency margin is to be prepared in accordance with Section 64 VA of the Insurance Act, 1938 and the same it to be certified by the auditor.

Appendix I
Format of Financial Statements
Form B-RA
Name of Insurer:

Registration No. and Date of Registration with IRDA

Revenue Account for the year ended 31st March, 20..
(To be prepared separately fire, marine, and miscellaneous insurance)

	Particulars	Schedule	Current Year (Rs. '000)	Previous Year (Rs. '000)
1	Premiums earned (Net)	1		
2	Profit/Loss on sale/redemption of investments			
3	Others (to be specified)			
4	Interest, Dividend & Rent-Gross			
Total (A)				
1	Claims incurred (Net0	2		
2	Commission	3		
3	Operating Expenses related to Insurance Business	4		
4	Others – To be specified			
Total (B)				
Operating Profit/(Loss) from Fire/Marine/Miscellaneous Business (A-B)				
Appropriations				
Transfer to Shareholders' Account				
Transfer toe Catastrophe Reserve				
Transfer to Other Reserves (to be specified)				
Total (C)				

FORM B-PL

Profit and Loss Account for the year ended 31st March 20…
Name of the Insurer:
Registration No. and Date of Registration with the IRDA

	Particulars	Schedule	Current Year (Rs. '000)	Previous Year (Rs. '000)
1	Operating Profit/(Loss) (a) Fire Insurance (b) Marine Insurance (c) Miscellaneous Insurance			
2	Income from Investments (a) Interest, Dividends & Rent-Gross (b) Profit on sale of investments LESS: Loss on sale of investments			
3	Other income (To be specified)			
Total (A)				
4	Provisions (other than taxation) (a) For diminution in the value of investments (b) Four doubtful debts (c) Others (to be specified)			
5	Other Expenses (a) Expenses other than those related to Insurance Business (b) Bad debts written off (c) Others (to be specified)			
Total (B)				
Profit Before Tax Provision for Taxation				
Appropriations (a) Interim dividends paid during the year (b) Proposed final dividend (c) Dividend distribution tax (d) Transfer to any Reserves or Other Accounts (to be specified)				
Balance of profit/loss brought forward from the last year				
Balance carried forward to Balance Sheet				

Note:

(a) Premium income received from business concluded in and outside India shall be separately disclosed.

(b) Reinsurance premiums whether on business ceded or accepted are to be brought into account gross (i.e. before deducting commissions) under the head reinsurance premiums.

(c) Claims incurred shall comprise claims paid, specific claims settlement costs wherever applicable and change in the outstanding provision for claims at the year-end.

(d) Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or Rs. 5, 00,000 whichever is higher, shall be shown as a separate line item.

(e) Fees and expenses connected with claims shall be included in claims.

(f) Under the sub-head “Others” shall be included items like foreign exchange gains or losses and other items.

(g) Interest, dividends and rentals receivables in connection with an investment should be stated as gross amount, the amount of income tax deducted at source being included under ‘advance taxes paid and taxes deducted at source’..

(h) Income from rent shall include only realized rent. It shall not include any notional rent.

Schedule 2
Claims Incurred (Net)

Particulars	Current year (‘000)	Previous year (‘000)
Claims paid Direct Add : Reinsurance accepted Less : Reinsurance Ceded Net Claims paid Add : claims Outstanding at the end of the year Less Claims Outstanding at the beginning Total Claims Incurred		

Notes :

a) Incurred But Not Reported (IBNR), Incurred But Not Enough Reported (IBNER) claims should be included in the amount for outstanding claims.

b) Claims include specific claims settlement costs but not expenses of management.

c) The surveyor fees, legal and other expenses shall also form part of claims cost.

d) Claims cost should be adjusted for estimated salvage value if there is a sufficient certainty of its realization.

Schedule 3
Commission

Particulars	Current year ('000)	Previous year ('000)
Commission paid Direct Add : Re-insurance Accepted Less : Commission on Re-Insurance Ceded Net Commission		
Note :The profit / commission, if any are to be combined with the Re-insurance accepted or Reinsurance ceded figures.		

Schedule 4
Operating Expenses Related to Insurance Business

	Particulars	Current year ('000)	Previous year ('000)
1.	Employees' remuneration & welfare benefits		
2.	Travel, conveyance and vehicle running expenses		
3.	Training Expenses		
4.	Rents, rates & taxes		
5.	Repairs		
6.	Printing & stationery		
7.	Communication		
8.	Legal & professional charges		
9.	Auditors fees, expenses etc.		

	a) as auditors		
	b) as adviser or in any other capacity, in respect of		
	i) Taxation matters		
	ii) Insurance Matters		
	iii) Management services; and		
	c) in any other capacity		
10.	Advertisement and publicity		
11.	Interest & Bank Charges		
12.	Others (to be specified)		
13.	Depreciation		
	Total		

Note : Items of expenses and income in excess of one percent of net premium or 5,00,000 whichever is higher, shall be shown as a separate line item.

Schedule 5
Share Capital

	Particulars	Current year (‘000)	Previous year (‘000)
1.	Authorised Capital		
	Equity Shares of ….. each		
2.	Issued Capital		
	Equity Shares of ….. each		
3.	Subscribed Capital		
	Equity Shares of ….. each		
4.	Call-up Capital		
	Equity Shares of ….. each		
	Less : Calls unpaid		
	Add : Equity Shares Forfeited		
	(Amount originally paid up)		
	Less : Par Value of Equity Shares Brought Back Expenses including commission or brokerage on Underwriting or subscription of shares		
	Total		

Notes :
a) Particulars of the different clauses of capital should be separately stated.
b) The amount capitalized on account of issued of bonus shares should be disclosed.
c) In case any part of the capital is held by a holding-company, the same should be separately disclosed.

Schedule 5A
Share capital Pattern of Shareholding
(As certified by the Management)

Shareholder	Current Year		Previous Year	
	Number of Shares	% of Holding	Number of Shares	% of Holding
Promoters Indian Foreign Others Total				

Schedule 6
Reserves and Surplus

	Particulars	Current year ('000)	Previous year ('000)
1. 2. 3. 4. 5. 6.	Capital Reserve Capital Redemption reserve Share Premium General Reserves Less : Debit balance in Profit and Loss Account Less : Amount utilized for Buy-back Catastrophe Reserve Other Reserves (to be specified)		
7.	Balance of Profit & Loss Account Total		

Notes :
a) Additions to and deductions from the reserves should be disclosed under each of the specified heads.

Schedule 7
Borrowings

	Particulars	Current year ('000)	Previous year ('000)
1.	Debentures / Bonds		
2.	Banks		
3.	Financial Institutions		
4.	Other (to be specified)		
	Total		

Notes :

a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.

b) Amounts due within 12 months from the date of Balance Sheet should be shown separately.

Schedule 8
Investment

	Particulars	Current year ('000)	Previous year ('000)
Long Term Investments			
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	a) Shares		
	i) Equity		
	ii) Preference		
	b) Mutual Funds		
	c) Derivative Instruments		
	d) Debentures / Bonds		
	e) Other Securities (to be specified)		

	f) Subsidiaries		
	g) Investment Properties – Real Estate		
	h) Investments in infrastructure and Social Sector		
	i) Other than Approved Investments		
Short Term Investments			
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	a) Shares		
	i) Equity		
	ii) Preference		
	b) Mutual Funds		
	c) Derivative Instruments		
	d) Debentures / Bonds		
	e) Other Securities (to be specified)		
	f) Subsidiaries		
	g) Investment Properties – Real Estate		
	h) Investments in infrastructure and Social Sector		
	i) Other than Approved Investments		
Total			
Investments			
1.	In India		
2.	Outside India		
Total			

Schedule 9
Loans

	Particulars	Current year ('000)	Previous year ('000)
1. Security –Wise Classification			
Secured			
a)	On mortgage of property		
	i) In India		
	ii) Outside India		
b)	On Shares, Bonds, Government Securities		
c)	Others (to be specified)		
	Unsecured		
Total			
2.	Borrower – Wise Classification		
a)	Central and State Governments		
b)	Banks and Financial Institutions		
c)	Subsidiaries		
d) Industrial undertakings			
e)	Others (to be specified)		
	Total		
3.	Performance-wise Classification		
	Loans Classified as standard		
	i) In India		
	ii) Outside India		
	Non-performing loans less provisions		
	i) In India		
	ii) Outside India		
	Total		
4.	Maturity-Wise Classification		
	a) Short-term		
b) Long Term			
Total			

Notes :

a) Short-term loans shall include those, which are repayable within 12 months of the balance sheet date. Long-term loans shall be the loans other than short-term loans.

b) Provisions against non-performing loans shall be shown separately.

c) The nature of the security in case of all long-term secured loans shall be specified in each case. Secured loans for the purposes of this Schedule, means loans secured wholly or partly against an asset of the company.

d) Loans considered doubtful and the amount of provision created against such loans shall be disclosed.

Schedule 10
Fixed Assets **('000)**

	Opening	Additions	Deductions	Closing	Upto last year	For the year	On sales / Adjustments	To Date	As at year end	Previous year
Goodwill Intangibles (specify)										
Land Freehold										
Leasehold property										
Buildings										
Furniture and Fittings										
Information Technology Equipment										
Vehicles										
Office Equipment										
Others (Specify nature)										
Total										
Work-in-Progress										
Grand Total										
Previous year										

Note :
Assets included in land, building and property above exclude Investment Properties as defined in note (e) to Schedule 8.

Schedule 11
Cash and Bank Balances

	Particulars	Current year ('000)	Previous year ('000)
1.	Cash (including cheques, drafts and stamps)		
2.	Bank Balances		
	a) Deposit Accounts		
	(aa) Short –term (due within 12 months)		
	(bb) Others		
	b) Current Accounts		
	c) Others (to be specified)		
3.	Money at Call and Short Notice		
	a) with Banks		
	b) with other Institutions		
4.	Others (to be specified)		
Total			
Balances with non-scheduled banks included in 2 and 3 above.			
Notes :			
Bank Balance may include remittances in transit. If so, the nature and amount should be separately stated.			

Schedule 12
Advances and Other Assets

	Particulars	Current year ('000)	Previous year ('000)
Advances			
1.	Reserve deposits with ceding companies		
2.	Application money for investments		
3.	Prepayments		
4.	Advances to Officers / Directors		

5.	Advance tax paid and taxes deducted at source (Net provisions for taxation)		
6.	Others (to be specified)		
Total (A)			
Other Assets			
1.	Income accrued on investment		
2.	Outstanding Premiums		
3.	Agents Balances		
4.	Foreign Agencies Balances		
5.	Due from other insurance entities (including reinsures)		
6.	Due from subsidiaries / holding		
7.	Deposit with Reserve Bank of India (Pursuant to Section 7 of Insurance Act, 1938)		
8.	Others (to be specified)		
Total (B)			
Total (A + B)			

Notes :

i) The items under the above heads shall note be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.

ii) The term ‘officer’ should conform to the definition of the word ‘officer’ given under the Companies Act, 1956.

iii) Sundry debtors will be shown under item 8.

Schedule 13
Current Liabilities

	Particulars	Current year ('000)	Previous year ('000)
1.	Agents' Balances		
2.	Balances due to other insurance companies		
3.	Deposits held on re-insurance ceded		
4.	Premiums received in advance		
5.	Unallocated Premium		
6.	Sundry creditors		
7.	Due to subsidiaries / holding company		
8.	Claims Outstanding		
9.	Due to Officers / Directors		
10.	Others (to be specified)		
8.	Others (to be specified)		
Total			

Schedule 14
Provisions

	Particulars	Current year ('000)	Previous year ('000)
1.	Reserve for Unexpired risk		
2.	For taxation (less advance tax paid and taxed deducted at source		
3.	For proposed dividends		
4.	For dividend distribution tax		
5.	Other (to be specified)		
Total			

Schedule 15
Miscellaneous Expenditure
(To the extent not written off or adjusted)

	Particulars	Current year ('000)	Previous year ('000)
1.	Discount Allowed in issue of shares / debentures		
2.	Others (to be specified)		
Total			

Notes :

No item shall be included under the head "Miscellaneous Expenditure and carried forward unless :

1. Some benefit from the expenditure can reasonable be expected to be received in future, and
2. The amount of such benefit is reasonable determinable.

   b) The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue / other benefits related to the expenditure.

APPENDIX II

Directions under Section 619 (3) (a) of the Companies Act, 1956, applicable to Insurance Companies

I. System of Accounts

1. Examine the following systems and give your views as regards their deficiencies alongwith suggestions for remedial measures : -
   a) Recording of receipts and expenditure.
   b) Drawing periodical trial balance.
   c) Compilation of accounts.
   d) Reconciliation of inter-office accounts.
   e) Reconciliation of registers / records relating to peroperty, assets. Investments, premiums, claims, loans, etc., with financial books.
   f) Maintenance of up-to-date records in respect of assets, which are pledged, encumbered or blocked in any way.

2. Are the bank accounts of the company reconciled with the bank statements regularly? If not, describe the failures.

3. Are control accounts and subsidiary accounts up-to-date and reconciled regularly? If not, describe the failures.

4. Examine the accounting policies of the company. Are these in conformity with the Accounting Standards (National and in

the absence of National Standards, the corresponding International Standard? Give particulars of material departures from these standards, if any, alongwith their effect on the financial statements; quantify the impact wherever possible.

II. System of Financial Control

1. Examine the delegation of financial powers and indicate whether these are clearly and legally made within the company. If not, describe the defects in the delegation of powers and suggest remedial measures.
2. Indicate whether the cash and imprest balances were physically verified during the year on a regular basis by an authorized officer? Highlight the inadequacies in this regard, if any.
3. Whether transfers of surplus funds are being made on a timely basis and whether these are being properly monitored?
4. Examine whether the system of the company insures adequate control over issue and custody of critical items of stationery, e.g., cover notes, policy documents receipts and acknowledgements relating to risk accepted, etc? If not, describe the inadequates.
5. Give your comments on Internal Audit system stating whether its reporting status, scope of work, level of competence, etc. are adequate? If not, describe the short-comings thereof. Is there an adequate compliance mechanism on internal audit observations?
6. Indicate the serious lacunae in the system of internal control which have come to your notice during audit.

III. Investments (Applicable only at H.O.)

1. Indicate whether the Board of Directors of the company laid down on investment policy? If yes, please indicate the following : -
   a) Is the policy in accordance with the laws, rules and regulations applicable to the company?
   b) In your opinion, are there any defects in the policy?
   c) Has the company followed it in case of all material investments made during the year?
   d) Were the investments made by the company in its best interest?

2. Does the company have adequate system of periodic physical verification of investments and reconciliation thereof with books? Have the discrepancies been properly dealt with?
3. Does the system of the company ensure proper recording of rights, entitlements and options on investments held? Are adequate records maintained in support of exercise / non exercise of such rights, etc?
4. Does the system of the company ensure recording of accrual of dividend, interest and other yields on investments and for follow up of the amounts accrued but not received?
5. In the case of investments matured and income due but not received / collected, is satisfactory explanation available for non-receipt / non-collection?

IV. Loans (Applicable only at H.O.)

1. Indicate whether the Board of Directors of the company has laid down a policy regarding of loans. If yes, please indicate the following :
   a) Is the policy in accordance with the laws, rules and regulations applicable to the company?
   b) In your opinion, are there any defects in the policy?
   c) Has the company followed it in the case of all material loans made during the years?
   d) Were the loans made by the company in its best interest?
   e) Has adequate provision been made in the accounts in respect of bad and doubtful loans? If not, describe the failures.
   f) Does the company have an effective system of identifying non-performing loans? Does the company monitor such loans effectively?
   g) Has the company taken adequate steps against the defaulters during the year? If not, indicate significant instances of failures.

V. Revenue Accounts

1. Does the company has an effective system to ensure that premiums for risks assumed / accepted during the year for various classes of business are properly computed and accounted for?

2. Is he system of collections of premium on policies issued adequate? If not, give instances of major violations of relevant legal provisions and prescribed procedures.
3. Have the norms for determining premium for non-tariff business been laid down by the company and are these followed by divisions / branches booking the business?
4. Have you come across instances of prohibited / declined risks having been accepted in excess of the delegated authority?
5. In respect of system relating to claims, comment on the following aspects, giving instances of significant deviations / failures in each case.

   a) Are claims promptly recorded in the claims intimation register for each class of business? Is the liability of the company ascertained / assessed expeditiously?
   b) Are surveyors appointed and their preliminary / final survey reports obtained within a reasonable time?
   c) Is collection and accounting of salvage as well as its disposal expeditious?
   d) Are close proximity claims, i.e., claims within a short period after commencement of the risk, identified? Are the procedures for processing of such claims effective?
   e) Are pending claims reviewed periodically and follow-up action taken in appropriate cases?
6. Does the system of the company ensure that claims are recorded net of co-insurance at the D.O./ branch and net of re-insurance as per arrangement with other insurers at the Head Office?
7. Is the system of monitoring the accepted or ceded business and accounting of premiums and claims in connection therewith adequate? Indicate major defects.
8. Are balances under accepted treaties periodically reconciled and action taken for outstanding recoveries?
9. Does the system of the company ensure proper recording of incoming and outgoing co-insurance transactions and periodic reconciliation of co-insurers balances?
10. Does the system of the company ensure periodic reconciliation of ledger balances relating to premiums and claims with the relevant figures as per the business

and claims registers as communicated by divisions in the underwriting returns for purpose of re-insurance?

11. Were the re-insurance treaties entered into by the company in its best interest? Indicate cases of re-insurance treaties which have resulted in heavy losses continuously.

VI. Miscellaneous

1. Are the (i) Premium deposit accounts, (ii) Bank guarantee account, (iii) Agent's balance accounts (iv) Outstanding premium accounts, (v) Amount due to and from other persons / bodies carrying on insurance business accounts, (vi) Treaty inwards and outwards control accounts, (vii) sundry debtors and creditors accounts including outstanding claims, regularly reviewed and pursued for clearance / adjustment? Have confirmations been obtained of such outstanding accounts? In the case of credit Balance including premium deposits, sundry deposits and agents balances, are appropriate premium adjustments made for risks assumed, if any?
2. Were there any special features in the year which have affected the results shown by the profit and Loss Account substantially? If so, give details.
3. Are these any other significant matters which in your opinion deserve the attention of the management?

Annexure – A

(This information is factual and should be obtained from the Management)

11.5 EXERCISE

1. Indicate the areas where the company has computerized the accounts system. Have the General and Application controls been reviewed periodically to derive assurance that the system is producing results that can be relied upon by the auditors? State the deficiencies reported by internal auditors / statutory auditors alongwith the remedial measures being taken by the management.
2. Are the accounts of the company in arrears? If so, state the reasons therefore and the action taken / being taken to bring the accounts up-to-date.
3. Please comment on operation of foreign branches / agencies with relevant details. In case of adverse results remedial measures taken and results thereof should be described.

4. What are non-performing investments? Please indicate the cost, book value and market value of such investments.
5. What is the average yield on investments in last three years?
6. What percentage of loans was considered doubtful at the end of each the three preceding years and the absolute amount thereof?
7. Give age-wise break-up of outstanding claims for each class of business (numbers and amount).
8. List out top 30 claims (above 5 lakhs each) provided / settled during the year (10 for each class of business).
9. Have any cases of frauds / embezzlements / misappropriation comes to light during the year? If so, give details.

1) In the case of firm letter of appointment of auditor must be signed by
 a) The partner b) The secretary
 c) The Auditor's himself d) All the partners

2) Formats of financial statements of a sole trader decided by
 a) Banker b) Sole proprietor
 c) Accountant d) All of the above

3) Admission fees of students can be checked from
 a) Roll call b) Admission slip signed by the principal
 c) Office identity cart d) None of the above

4) The auditor of an educational body should verify that increase in salary is minuted by
 a) Principal b) Voice principal
 b) Accountant d) Managing committee

5) The Auditor of a sole trade is appointed by
 a) Banker b) Accountant
 c) Proprietor d) None of the above

6) The auditors of educational body should ensure that any income from special fund is credited to
 a) Capital fund account b) Special fund account
 c) Investment account d) Income & Expenditure Account

7) The auditor of a firm must have knowledge of
 a) Partnership Deed b) Provisions of Partnership Act
 c) Companies Act d) Both a & b

8) Audit of a small company may be done by
 a) Company Secretary b) Accountant
 c) Chartered Accountant d) Cost Accountant

9) In audit of Sole trader auditor's duties are defined by
 a) Banker b) Companies Act
 c) Accountant d) Contract between auditor and client

10) In the case of hospital bills issued to patients is verified from
 a) Invoices b) Investigation Reports
 c) Register of patients d) Case papers

11) In the case of a soll trader payment of tax liabilities
 a) Compulsory b) Optional
 c) Determined by the banker d)None of the above

12) Inventory of an Educational Institution is verified from the
 a) Stock Register b) Purchase Register
 c) Bank Statement d) Cash Book

13) The auditor should ensure that the business of firm is authorized by
 a) Managing Partner b) Sleeping Partner
 c) Partnership deed d) Memorandum of Association

14) In the case of a partnership firm
 a) The partnership Act Prescribed audit
 b) The partnership deed provides for audit
 c) The companies act prescribed audit
 d) The partnership Act does not prescribed audit

15) The auditor should ensure that the caution money and other deposits from students are shown in the
 a) Balance sheet on liability side b) Balance sheet on asset side
 c) Foot note to the Balance sheet d) None of the above

16) The document which contains the provisions attesting the accounts of a firm.
 a) Memorandum of Association b) Lease deed
 c) Partnership deed d) Trust deed

17) The record of policies decision is
 a) Agenda Book b) Minute Book
 c) Cash Book d) Notice Book

18) In absence of partnership deed frofits are shared by partner's in
   a) Equally
   b) Ratio of time devoted by partners
   c) Ratio of Capitals
   d) As per seniority

19) Verification of grants from Government or Local authority can be done from
   a) Memo of Grants
   b) Principals letter
   c) Managing committees minutes
   d) Stock Register

20) In absence of partnership deed partners entitled to interst on their advances/loans
   a) 4%
   b) 6%
   c) 12%
   d) 18%

21) In the case of Educational Institutions decision altecting the accounts are recorded in
   a) Accountants Diary
   b) Principals Diary
   c) Minutes of managing committee or Governing body
   d) Financial Statements

22) The Certificates regarding completion of accounting records and its accuracy should be obtained from
   a) MD of the company
   b) Management of the company
   c) Accountant of the Company
   d) Owner of the company

23) In the case of Educational Institutions, details about the students can be obtained from
   a) Attendance register
   b) Examination Report
   c) Student Register
   d) General Register

24) In absence of partnership deed
   a) Profits and Losses are shared equally
   b) Profits and Losses are shared in the ratio of their capitals
   c) Loss of the firm is not shared at all
   d) Profit & Losses are shared in the ratio 3:2:1

25) In absence of partnership deed
   a) Interest on Capital is gives at 18% p.a.
   b) Interest on Capital Cannot be given
   c) Interest on capital is given at 6% p.a.
   d) Interest on capital is given at 12% p.a.

26) Verification of free studentship and concessions granted can be done from rulls prepared by
a) Staff
b) Managing Committee
c) Student
d) Principal

27) In view of the small size of a small company
a) In may be possible to check 100% of the entries
b) Only Balance sheet audit can be done
c) Audit of trial balance can be done
d) Only cash book can be audited

28) In the case of Educational Institutions, all the provisions affecting the accounts are given in
a) Articles of association
b) Memorandum of association
c) Trust deed
d) Partnership deed

29) The tax auditor has to submit his report to
a) The assesses
b) The Government
c) Income tax officer
d) Income tax Commissioner

30) As per Income Tax Act Gross Receipts include
a) Wire charges of cold storage
b) Lease Rant
c) Cash incentives for export
d) All of the above

31) Form No. 3 CB is used carries on business/profession but not required any law to get its account audited
a) The person who carries on business/profession but not required any law to get its account audited
b) The person who carries on business but required to get his accounts audited
c) A Limited Company
d) A person who is not a business man or professional

32) Tax audit is provided by section
a) 41
b) 42 A
c) 43 B
d) 44 AB

33) Claims are verified by checking
a) Policies
b) Claim form
c) Survey Report
d) All of the above

34) The very first item in the balance sheet of a banking company on asset side is
a) Cash & Balance with RBI
b) Fixed Asset
c) Goodwill
d) Investments

35) Stock verification of hospital can be done from
a) Stock Register b) Admission card
c) Prescription issued d) Discharge card

36) As per Income Tax Act. Cross Receipts includes
a) Cash incentives for export b) Salle of fixed assets
c) Cash collected from debtors d) None of the above

37) Premium is verified by checking
a) Premium receipt issued b) Branch managers minutes book
c) Claims settled book d) Survey Report

38) Tax audit is compulsory for those businessmen whose turn over or gross receipts exceed
a) 20 lakh b) 40 lakh
c) 60 lakh c) 80 lakh

39) Stock of furniture, sports material and other assets should be verified with the
a) Purchase Register b) Stock register
c) Cash book d) Sales Receipt Book

40) Every banking company in India has to transfer to Reserve fund out of current year profit
a) 20% b) 25%
c0 30% d) 40%

41) Cash collection from patients can be verified from
a) Discharge card b) Case papers
c) Receipt issued to patient d) Investigation Report

42) The audit report is required to be furnished under section 44AB shall be
a) 3 CB b) ITR2
c) 3 CA d) Saral

43) The auditor should evaluate the internal control regarding
a) Receipt of cash b) Disbursting of cash
c) Billing to customers d) All of the above

44) While verifying 3 CD form it is advisable for the tax auditor to consider
a) Cross references b) Difference of opinion
d) Law applicable d) All of the above

45) The auditor of a hotel should ensure
a) Articles of association b) provision of company law
c) Statutory compliance d) Rules of FEMA

46) Every insurance company has to prepare every year
a) Balance sheet & Profit & Loss A/c.
b) Statement of claims refected
c) Undertaking for acknowledging claims
d) Fund flow statement

47) Reserve for unexpired risk is shown in the balance sheet of a General Insurance company under
a) Capital & Reserves
b) Current liabilities
c) Provision
d) None of the above

48) In the case of club entrance fees can be verified from
a) Counterfoils issued
b) Journal Entries
c) Members Entry book
c) Secretaries minute book

49) Specified date by which tax audit should be done is
a) 31^{st} October of A.Y.
b) 31^{st} December of A.Y.
c) 31^{st} July of A.Y.
d) 3oth September of A.Y.

50) The auditor of a hotel should ensure that proper provision is made for
a) Redecoration
b) Renovation
c) Repairs
c) All of the above

51) Audit report to be given by the auditor of an insurance company must be as per
a) Schedule of IRDA
b) Form 3 CB & 3 CD
c) Schedule 6 of companies Act
d) Provision of Income Tax Act

52) Tax audit is compulsory for those professionals whose gross receipts in any previous year exceed
a) 10 lakh
b) 15 lakh
c) 20 lakh
d) 25 lakh

53) Figures in final accounts of a bank are shown in
a) Rupees
b) Hundreds
c) Thousands
d) Lakhs

54) Outstanding premium is shown in the Balance sheet of an insurance company under
a) Current asset
b) Current liabilities
c) Other asset
d) Misl. Expenditure

55) Payment to foreign collaborator should be as per
a) Terms of agreement
b) Trust deed
c) Partnership deed
d) Letter of credit

56) Premium received in advance is shown in the balance sheet of Insurance Company under the Lead
a) Current Asset b) Current liabilities
c) Other asset d) Misc. Expenditure

57) Special receipts from letting out the auditorium in the hotel should be verified on the basis of
a) Counter fails of Receipt issued
b) Bank reconciliation statement
c) Articles of association
d) Memorandum Association

58) As per Income Tax Act, Sales include
a) Sale of scrap b) Sale of fixed asset
c) Sale of investment d) Sale of business

59) Insurance business is controlled by
a) IRDA b) Insurance rules
c) Insurance Act, 1938 d) All of the above

60) As per Section 44AA profession does not includes
a) Legal b) Banking
c) Medical d) Accountancy

61) For settlement of claim, Insurance Company
a) Ensures completion formalities
b) Decides genuineness of the claim
c) Survey Report
d) All of the above

62) The reserve for unexpired risk in respect of marine insurance is
a) 20% of premium b) 25% of premium
c) 50% of premium c) 100% of premium

63) In case of under Insurance by parties
a) Interest clause applied b) Average clause applied
c) Claim clause applied d) All of the above

64) Inter office adjustment is shown in the bank balance sheet under
a) Advances b) Either other assets of other liabilities
c) Deposits d) Contra entries

65) Which of the following is generally the largest item of the asset side of the bank balance sheet?
a) Loans & advances b) Other asset
c) Cash & bank balance with RBI
d) Deposits

66) Bills for collection are shown in the balance sheet of a bank under

a) Other asset
b) Advances
c) Deposits
d) Contingent liabilities

67) Endorsement are shown by banks under

a) Other assets
b) other liabilities
c) Contingent liabilities
d) Deposits

68) Bills payable are shown in the balance sheet of a bank under

a) Contingent liabilities
b) Other liabilities & provisions
c) Advances
d) Deposits

69) In case of Nationalized bank the auditor shall sent his report to

a) President of India with a copy to RBI
b) Central Government
c) RBI
d) Managing Director of the bank

70) Discount on bills is shown by banks under schedule number

a) 12
b) 13
c) 14
d) 15

71) Rebate on bills discounted is shown in balance sheet of bank under

a) Liability side
b) Asset side
c) Asset & liabilities both
d) None of the abve

72) Rebate on bills discounted is shown in balance sheet of bank under

a) 4
b) 5
c) 9
d) 10

73) Letters of credit are shown under

a) Other assets
b) Other liabilities
c) Contingent liabilities
d) Advances

74) Unclaimed dividend is shown by banks under

a) Advances
b) Deposits
c) Other assets
d) Other liabilities

75) Banks should classify an account as NPA only if interest charged during any quarter is not served fully with days from the end of the quarter

a) 30
b) 60
c) 90
d) 120

Answers:
1 – a, 2 – a, 3 – b, 4 – d, 5 – c, 6 – b, 7 – d, 8 – c, 9 – d 10 – c
11 – a, 12 – a, 13 – c, 14 – d, 15 – a, 16 – c, 17 – b, 18 – a, 19 – a, 20 – b,
21 – c, 22 – d, 23 – c, 24 – a, 25 – c, 26 – b, 27 – a, 28 – c, 29 – a, 30 – d,
31 – a, 32 – d, 33 – d, 34 – a, 35 – a, 36 – a, 37 – a, 38 – c, 39 – b, 40 – a,
41 – c, 42 – a, 43 – d, 44 – d, 45 – c, 46 – a, 47 – c, 48 – a, 49 – a, 50 – a,
51 – a, 52 – b, 53 – c, 54 – c, 55 – a, 56 – b, 57 – a, 57 – d, 60 – b, 61 – d,
62 – d, 63 – b, 64 – b, 65 – a, 66 – d, 67 – d, 68 – b, 69 – a, 70 – b, 71 – a,
72 – c, 73 – c, 74 – d, 75 – c.

Fill in the blanks

1) Bills payable is shown in the balance sheet of a bank under ______
2) Tax audit is provide by section _______
3) The Tax auditor has to submit is report to ______
4) Auditor of a sole trader is appointed by the ______
5) Auditor of a firm must have knowledge of ______
6) Auditor of a small company may be done by a sole _____
7) The auditor of a hotel should ensure _____
8) Bills purchased and discounted are shown in the balance sheet of a bank under schedule of ______
9) In case of a sale trader _____ decides the scope of audit
10) Sale of scrap is included in gross ______
11) _____ contains provision affecting accounts of a firm
12) Admission fees of students can checked from ____
13) Bills for collection are shown in the balance sheet of a bank under ______
14) ______ regulates the working of insurance companies
15) ______ shows inventory of the educational institutions
16) Forma of financial statements of a sole trader is decided by ______
17) Average clause is applicable in case of ______
18) In absence of partnership deep profit or loss is shared by partners _____
19) In the case of hospitals cash collection from patients is verified from ______
20) Reserve for unexpired risk in respect of fire insurance is______
21) In the case of a club stock verification can be done from______
22) Outstanding premium is shown in the balance sheet of an insurance company under ______
23) Caution money is disclosed in the balance sheet on ______
24) In absence of partnership deed partners are entitled to interest on loan at ______%

Answers:

1) Other liabilities

2) 44AB

3) Assessee

4) Sole proprietor

5) Partnership deed/partnership act

6) CA 7) Statutory compliance

8) Advances/Schedule 9

9) Owner/proprietor

10) Receipts

11) Partnership deed

12) Admission slips/fee receipts

13) Contingent liabilities

14) IRDA

15) Stock Register

16) ICAI

17) Under Insurance

18) Equally

19) Cash bank

20) 50%

21) Stock register

22) Other assets

23) Liabilities side

24) 6%.

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12

BANKING COMPANY AUDIT

Unit Structure

12.1 INTRODUCTION

Banking means accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft or otherwise.

A banking company means any company which transacts business of banking in India

Presently, there are following four types of banking institutions in India:

(a) Commercial banks;
(b) Regional rural banks;
(c) Co-operative banks; and
(d) Development banks (more commonly known as 'term-lending institutions')

12.2 ROLE OF THE RESERVE BANKS OF INDIA AS CENTRAL BANK

The RBI is the central bank of our country. As such, RBI is responsible for development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions) as well as for determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks. No bank can commerce the business of banking or open new branches without obtaining license from RBI. The RBI also has the power to inspect any bank.

The text of the notifications/circulars/guidelines, etc., issued by RBI is normally also available on its website www.rbi.org.in.

A banking company needs to hold a license issued by RBI to do the business of banking in India. There is an elaborate legal framework governing the functioning of banks in India. The auditor must have knowledge of all these acts.

The principal enactments which govern the functioning of various types of banks are:

- Banking Regulation Act, 1949
- State Bank of India Act, 1955
- Companies Act, 1956
- State Bank of India (Subsidiary Banks) Act, 1959
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- Regional Rural Banks Act, 1976
- Banking Companies (Acquisitions 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

The auditor should also note that

- A banking company is not allowed to carry on any business except those business which are permitted under sec 6 (1) of the Act.
- No brokerage , discount or remmuration or sale of shares exceed 2.5%
- A Bank cannot form a subsidiary company
- It cannot create a charge on its unpaid capital
- Prior approval of RBI is necessary for appointment or reappointment of a MD, whole time director or manager or CEO.
- The banks have custody of large volumes of cash negotiable instrument whose physical security has to be ensured. There are many chances of misappropriation or fraud. The bank engaged in a large volume and variety of transaction in terms of both number and volumes therefore the branch must have formal operating procedures, well defined limits for individual discretion and rigorous system of internal control.

- Banks normally operate though a wide network of branches and department which are spread nationwide this involves a greater decentralization of authority.

12.3 APPOINTMENT OF AUDITOR

A. The Reserve Bank of India appoints the auditor who is duly qualified to be an auditor of company.

B. Compliance u/s. 226 (3) of Companies Act, 1956 with regard to qualification and disqualifications of auditors.

None of the following persons shall be qualified for appointment as auditor of a company-

a. A body corporate;
b. An officer or employee of the company;
c. A person who is a partner, or who is in the employment, of an officer or employee of the company;
d. A person who is indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees;
e. A person holding any security of that company after a period of one year from the date of the companies (Amendment) Act, 2000. Internal Auditor cannot be statutory auditor for the same financial year.
f. The nature of audit work has to be ascertained as to whether it is Concurrent Audit, Stock Audit, Revenue Audit, Credit Risk Auditor or any other Assignments of any branch of that bank.
g. Decision of Acceptance or Rejection of Assignment has to communicated to the concerned authority
h. It should be ensured that minimum fees are set as per RBI circular.

12.4 STRUCTURE OF INTERNAL CONTROL PROCEDURES IN A BANK

The specific internal control procedures to be followed in an enterprise depend on the nature, volume and complexities of its operations and the management's attitude towards control. However, as in the case of other enterprises, the internal control procedures relevant to assertions made in the financial statements of bank generally fall under the following categories;

I. Segregation and Rotation of Duties
II. Authorization of Transactions
III. Maintenance of Adequate Records and Documents
IV. Accountability for, and Safeguarding of, Assets

V. System Configuration and Account Mapping
VI. Independent Checks

- **Remuneration of Auditor**

The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of section 224 of the Companies Act, 1956 (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 nationalized banks and State Bank of India is to be fixed by the RBI in consultation with the Central Government. The remuneration of auditors of subsidiaries o State Bank of India is to be fixed by the latter. In the case of regional rural banks, the auditor's remuneration is to be determined by the bank concerned with the approval of the Central Government.

- **Prior preparation of Audit:**

The auditor has to ensure following before accepting the bank audit

1. He should not accept the audit if he is concurrent auditor or internal auditor

2. He should obtain NOC from the previous auditor

3. Exact location of branch /bank

4. Last date of submission of report

5. The banks normally do direct voucher posting to ledger accounts. The auditor must understand the accounting procedure of bank thoroughly well

6. The auditor should study the reports of previous auditor, concurrent audit, internal auditor and compute system auditor

7. The auditor should also obtain study various notifications, circulars and guide lines issued by the RBI from time to time.and kept ready for reference.

8. Engagement Letter under AAS 26 has to be issued

9. There must be a Communication with joint auditor as per AAS 12

10. A list of accounting standards applicable to the branch must be prepared

11. Copy of all circulars of RBI applicable to branch have to be obtained and kept ready for reference.

12. Attending branch audit seminars could enhance the auditors knowledge on bank audits

13. Banking terminology and schemes should be well understood

14. Guidance notes issued by ICAI on audit of banks

15. Internal circulars issued by the banks for assisting their staff for maintaining of books of accounts

16. All the banks have computerized their accounts. The auditor must understand the software and study the report of system auditor.

The auditor should prepare detailed audit programme which should adequately cover his scope of work giving proper weightage to areas of weak internal controls.

12.5 AUDITOR'S REPORT

In the case of a nationalized bank, the auditor is required to make a report to the Central Government in which he has to state the following:

(a) Whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit 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 transaction of the bank, which have to come to his notice, have been 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;

(d) Whether the profit and loss account shows a true balance of profit or loss for the period covered by such accounts; and

(e) Any other matter which he considers should be brought to be the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalized bank.

The auditor's report in the case of subsidiaries of State Bank of India is identical to the auditor's report in the case of a nationalized bank, except that all references to central Government have to be construed instead as references to the State Bank of India. Similar is the position in the case of regional rural banks, except that the references are instead to the bank concerned.

- **Format of Audit Report**

The auditor's central as well as branch, should also ensure that the audit report issued by them complies with the requirements of Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", SA 705 , "Modifications to the Opinion in Independent Auditor's Report" and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's 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,.

In addition to matters on which he is required to report to the shareholders under the Companies Act, 1956, the auditor of a banking company is also required to state in his report:

(a) Whether or not the information and explanations required by him have been found to be satisfactory;

(b) Whether or not the transactions of the company which have come to his notice have been within the powers of the company;

(c) Whether or not the returns received from the branch offices of the company have been found adequate for the purpose of his audit.

(d) Whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

(e) Any other matter which he considers should be brought to the notice of the shareholders of the company.

It may be noted that in the case of a banking company, by virtue of the provisions of clause (d) of sub-section (3) of section 227 of the Companies Act, 1956, the auditor has to specifically report whether, in his opinion, the profit and loss account and balance sheet of the banking company comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

The Companies (Amendment) Act, 2000 has inserted two new clauses (e) and (f) in section 227(3) of the Companies Act, 1956. Clause (e) requires that the auditor's report shall state "in thick type or in italics the observations or comments of the auditors which have any adverse effect on the function of the company". Clause (f) requires the auditor to report "whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274". Member's attention is invited to the Revised Guidance Note on section 227(3) (e) and (f) of the Companies Act, 1956.

It may also be noted the Companies (Auditor's Report) Order, 2003 (Revised in 2005), is not applicable to banking companies.

- **Long Form Audit Report**

Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditor 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 (LFAE). The matters which the banks require their auditors to deal with in the long form audit report have been specified by the RBI.

12.6 POWERS OF AUDITOR

The auditor of a banking company has the same powers as those of a company auditor in the matter of access to the books, accounts, documents and vouchers. He is also entitled to require from the offices of the bank such information and explanations as he mey think necessary for the performance of his duties. In the case of a banking company, he is entitled to receive notice relating to the any general meeting. He is also entitled to attend any general meeting and to be heard there at on any part of the business, which concerns him as an auditor.

It is important to note that under section 10 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, the auditor of a nationalized bank may employ accountants or other persons at the expense of the bank to assist him in audit of accounts.

12.7 AUDIT OF SOME IMPORTANT ITEMS

1. Share Capital

The auditor should verify the opening balance of capital with reference to the audited balance sheet of the previous year. In case there has been an increase in capital during the year, the auditor should examine the relevant documents supporting the increase. For example, in case of an increase in the authorized capital of a banking company, the auditor should examine the special resolution of shareholders and the memorandum of association. An increase in subscribed and paid-up capital of a banking company, on the other hand, should be verified with reference to prospectus/other offer document, reports received from registrars to the issue, bank statement, etc. Compliance with section 14 of the Banking Regulation Act, 1949, should also be examined. In cae of increase in capital of a nationalized bank through fresh contributions by the government, the auditor should examine correspondence/government notification or order, bank statement, etc.

In the case of newly formed banking companies/ places of business established in India for the first time by a banking company incorporated outside India, the auditor should also examine compliance with the provisions of section 11 and 12 of the Banking Regulation Act,1949.

The auditor should also check the compliance with capital adequacy requirements for banks. The auditor should verify the compliance with the RBI reporting and other requirements issued from time to time.

As per the Act, capital of the bank should disclose separately the authorized capital, issued capital and subscribed capital, stating separately the number of shares and the value of shares. If the bank has issued shares for consideration other than cash then proper disclosure of the same should be made.

2. Reserves and Surplus

The auditor should verify the opening balances of various reserves with reference to the audited balance sheet of the previous year. Additions to or deductions from reserves should also be verified in the usual manner, e.g., with reference to board resolution. In the case of statutory reserves and securities premium, compliance with legal requirements should also be examined. Thus, the auditor should specifically examine whether the requirement of the governing legislation regarding transfer of the prescribed percentage of profits to reserve fund have been complied with. In case the bank has been granted exemption from such transfer, the auditor should examine the relevant documents granting such exemption. Similarly, it should be examined whether the appropriations from securities premium account conform to the relevant legal requirements.

Where the local laws or regulations governing overseas branches requires creation of certain reserves, the auditor should examine compliance with the relevant requirements concerning the quantum and manner of disclosure of such reserves. The auditor should also ascertain that whenever necessary to secure compliance with the local laws of the respective foreign countries, separate identity of such reserves has been maintained in the balance sheet of the bank as a whole. The auditor should also ascertain that all provisions. Regarding eligibility criteria and quantum of dividend have been fulfilled in respect of dividend paid by the bank, if any, during the year.

The auditor should examine the nature of various accounts included under this head to ensure that only accounts in the nature of reserves are included. The auditor should verify whether the utilizations of reserves are in accordance with regulatory and statutory requirements and whether the reporting requirements have been complied with in terms of the requirements of Banking Regulation Act, 1949 and the Guidelines of the RBI, issued from time to time.

“Statutory Liquidity Ratio (SLR)” Banking companies are required to maintain cash, gold or unencumbered securities on account as determined by RBI from time to time of aggregate of their demand and time liabilities in India as on last Friday of preceding fortnight.

The auditor should verify the compliance of SLR on 12 selected odd dates in different months not being Fridays.

As per RBI guidelines following points should be verified in this regards:

- Composition of items of DTL
- Verification of trial balance and cash balance for 12 selected dates by the branch auditor
- Inclusion of demand and time liabilities in consolidated statements
- Net credit balance in Branch Adjustment A/c
- Liquid Asset should include deposits with RBI, cash balance with the bank and with RBI, excess balance with RBI u/s 42 and net balance in current A/c
- Price of gold should not exceed market price.

The auditor should ensure that 20% of the current year profit of the bank has been transferred to reserve fund as per the provisions of section 17 of the Act. He should also verify the appropriations made out of this reserve.

3. Deposits

Banks accept various deposits which are current deposits or time deposit such as current accounts, fixed deposits, saving deposits etc.

<u>Current deposits</u>: The auditor should verify balances in individual accounts on test check basis. He should also obtain confirmations from some of them. He should also see that total of individual account is in confirmation with control accounts Debit balances in currents accounts should not be subtracted from credit balances of current accounts. They should be shown under the head advances (Schedule No.9) special attention should be given in operative accounts.

Saving bank account: The auditor should verify balances in individual accounts on test check basis. He should also see that total of individual account is in confirmation with control accounts. The auditor should also check interest calculation on sampling basis.

Term Deposits (fixed deposits): The auditor should evaluate the internal control system. Ensure that serial numbers are given to deposit receipts and cash certificates. Unissued and unused deposit certificates and cash certificates are in proper custody. Examine and ensure that the rates of interest calculation are properly done. Check the entries in relevant register.

In carrying out audit of deposits and liabilities, the auditor is primarily concerned with obtaining reasonable assurance that all known liabilities are recorded and stated at appropriate amounts.

The auditor may verify various types of deposits in the following manner:

Current Accounts

The auditor should verify the balances individual accounts on a sampling basis. He should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

Some banks have a procedure for obtaining confirmation of balances periodically. The auditor should examine whether the procedure laid down in this behalf has been followed consistently throughout the year. He should also examine, on a sampling basis, the confirmations received.

The auditor should ensure that debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head ‘advances’.

Inoperative accounts are a common area of frauds in banks. While examining current accounts, the auditor should specifically cover in his sample some of the inoperative accounts revived during the year. The auditor should also ascertain whether inoperative accounts are ‘revived’ only with proper authority. For this purpose, the auditor should identify cases where there has been a significant reduction in balances compared to the previous year and examine the authorization for withdrawals.

Saving Bank Deposits

The auditor should verify the balances in individual accounts on a sampling a basis. He should also examine whether the balance as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regards.

The auditor should also check the calculations of interest on a sampling basis. It is not unusual for branches to compute interest savings bank up to a date close to the end of the accounting period e.g. 25th March based on the actual balances with interest for the remaining period on an estimated basis at the head office level.

As in the case of current accounts, the auditor should ay special attention to inoperative savings bank accounts.

Term Deposits

While evaluating the internal controls over term deposits, the auditor should specifically examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the register. The auditor should also satisfy himself that there is a proper control over the unused forms of deposit receipts and cash certificates to prevent their misuse.

As stated earlier, the rate of interest on Certificates of Deposits (CDs) is negotiable with the counter-foils of the receipts issued and with the discharged receipts returned to the bank. The reconciliation of subsidiary records for various types of term deposits with the related control accounts in the General Ledger should be examined. The auditor should also examine whether provision has been made for interest accrued on the deposits up to date of the balance sheet. Auditor should ensure that proper provision for interest payable on deposits is made.

In some cases, banks employ some persona as ‘collectors’ to collect the deposits from depositors, e.g., in case of recurring deposits. In such cases, the auditor should specifically examine the efficacy of the internal control procedures for reconciling the records of the bank with those of the collectors.

The term deposits from banks are usually (though not necessarily) in round figures. Any odd balances should, therefore, put the auditor to enquiry.

Deposits Designated in Foreign Currencies

In the case of deposits designated in a foreign currency, e.g., foreign currency non-resident deposits, the auditor should examine whether they have been converted into Indian rupees at the rate notified in this behalf by the head office. The auditor should also examine whether any resultant increase or decrease has been taken to the profit and loss account. It may also be seen that interest on deposits has been paid on the basis of 360 days in a year. Further, in case of conversion of FCNR (B) deposits into NRE deposits or vice versa before maturity has been subjected to the provisions relating to premature withdrawal.

Interest Accrued But Not Due

The auditor should examine that interest accrued but not due on deposits is not included under the relevant deposits but is shown under the head ‘other liabilities and provisions’.

4. Borrowings

The auditor should examine documentary evidence for borrowings, classification of borrowing in India and outside India, secured and unsecured. He should also ensure that inter branch transactions/balances are not shown under this head. Refinance obtained from RBI is shown under this head.

Borrowings usually take place only at a few designated branches authorized in this behalf by the head office of other controlling authority either generally or specifically in respect of a particular borrowing. As such, this item generally does not figure in the balance sheets of most branches of the bank.

Borrowings from RBI, other banks/financial institutions, etc. should be verified by the auditor with reference to confirmation certificates and other supporting documents such as, agreements, correspondence, etc. Audit evidence in the form of external confirmations received directly by the auditor from appropriate conforming parties may assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of material misstatement.

The auditor should also examine whether a clear distinction has been made between ‘rediscount’ and ‘reference’ for disclosure of the amount under the above head since rediscount does not figure under this head.

The auditor should examine whether borrowings of money at call and short notice are properly authorized. The rate of interest paid/payable on, as well as duration of such borrowings should also be examined by the auditor.

The auditor should similarly examine the relevant correspondence or other documents to ensure that the branch has been authorized by the head office to borrow/retain other borrowings and that the terms on which borrowings have been made are in accordance with the authorization.

The auditor should examine whether the amount shown in the branch accounts is properly classified based on security or other wise.

The auditor may verify the various items under the head ‘other liabilities and provisions’ in the following manner.

5. Bills Payable

The auditor should evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following:

(a) Drafts, mail transfers, traveler’s cheques, etc. should be made out in standards printed forms.

(b) Unused forms relating to drafts, traveler’s cheques, etc. should be kept under the custody of a responsible offices.

(c) The bank should have a reliable private code known only to the responsible officers of its branches coding and decoding of the telegrams should be done only by such officers.

(d) The signatures on a demand draft should be checked by an officer with the specimen signature book.

(e) All the telegraphic transfers and demand drafts issued by a branch should be immediately confirmed by advices to the branches concerned.

On payment of these instrument, the paying branch should send a debit advice to the originating branch.

(f) If the paying branch does not receive proper confirmation of any telegraphic transfers or demand draft from the issuing branch, it should take immediate steps to ascertain the reasons.

(g) In case an instrument prepared on a security paper, e.g. draft, has to be cancelled (say, due to error in preparation), it should be ensured that the manner of cancellation is such that the instrument cannot be misused. (For example, in the case of drafts, banks generally cut the distinctive serial number printed on the form and paste it in the book in which drafts issued are entered). Cases of frequent cancellation and re-issuance of drafts, pay order, etc. should be carefully looked into by a responsible official.

Based on his evaluation of the efficacy of the relevant internal controls, the auditor should examine an appropriate sample of outstanding items comprised in bills payable accounts with the relevant registers. Reasons for old outstanding debits in respect of drafts or other similar instruments paid without advice should be ascertained. Correspondence with other branches after the year-end (e.g., responding advices received from other branches, advices received from other branches in respect of drafts issued by the branch and paid by the other branches without device) should also be examined specially in so far as large value items outstanding on the balance sheet date are concerned.

6. Others (Including Provisions)

It may be noted that the figure of advances and investments in the balance sheet of a bank excludes provisions in respect thereof made of the satisfaction of auditors. The auditor should examine other provisions and other items of liabilities in the same manner as in the case of other entities.

7. Cash

The auditor should count the balance of cash on hand. As far as possible, the auditor should visit the branch at the close of business on the last working day of the year or before the commencement of business on the next day for carrying out the physical verification of cash. If, for any reason, the auditor is unable to do so, he should carry out the physical verification of cash as close to the balance sheet date as possible. It is sometimes arranged by the branch to deposit a large portion of its cash balance with the RBI or the State Bank of India or any other bank on the closing day, in which case, the work of the auditor is reduced substantially; however, the auditor must request the branch to provide sufficient appropriate evidence for the same.

Care should be taken to ensure that if cash is kept separately in different departments or at different locations (e.g. at extension counters), all the balances are verified by the auditor simultaneously. He should also ensure that there is no movement of cash till the counting is over.

The auditor should evaluate the effectiveness of the system of internal controls in branch regarding daily verification of cash, maintenance of cash related registers and vault register, custody of keys, daily cash holding and retention limit of the branch, etc. The auditor should ensure that a global policy has been taken for safety of cash from a theft or burglary and such policy is effective.

For physically verifying the cash-on-hand, the auditor may proceed as below:

(a) Physically verify the cash-on-hand. The extent of verification would depend upon the auditor’s assessment of the efficacy of internal control system including adherence to cash retention limits fixed by the head office, mode of custody of cash

(b) Obtain a certificate indicating denomination-wise cash balance as per physical verification.

8. Balance with RBI

In a bank, only a few select branches are designated to have account with the RBI. Thus, this item would not appear in the balance sheet of every branch. The following procedures, therefore, applicable only to branches having account with the RBI.

The auditor should verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at year end. The auditor should review the reconciliation statements. He should pay special attention to the following items appearing in the reconciliation statements: (i) cash transactions remaining responded; (ii) revenue items requiring adjustments/write-offs; and (iii) old outstanding balances remaining unexplained/unadjusted for over one year.

The auditor should obtain a written explanation from the management as to the reasons for old outstanding transaction in bank reconciliation statements remaining unexplained / unadjusted for over one year.

9. Balance with Banks (Other than Reserve Bank of India)

The auditor should also apply the procedures described in paragraphs above in examining the balances with banks other than RBI. While reviewing the reconciliation statements, the auditor should pay particular attention to the following:

(a) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc., are not made separately in the statement of account.

(b) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheque returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.

(c) Examine that all bills or outstanding cheque sent for collection and outstanding as on the closing date have been credited subsequently.

The auditor should also examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.

In respect of balances in deposit accounts, original deposit receipts should be examined in addition to confirmation certificates obtained from banks in respect of outstanding deposits. Balances in deposit accounts are usually (though not necessarily) in round figures. Where such balances are in odd figures, the auditor should enquire whether the account concerned is actually of the nature of a deposit account.

The balances with banks outside India should also be verified in the manner described above. These balances should be converted into the Indian currency at the exchange rates prevailing on the balance sheet date.

10. Money at Call and Short Notice:

The auditor should examine whether there is a proper authorization, general or specific, for lending of the money at call or short notice. Compliance with the instructions or guidelines laid down in this behalf by the head office or controlling office of the branch, including the limits on lending's in inter-bank call money market, should also be examined.

Call loans should be verified with the certificates of the borrowers and the call loan receipts held by the bank. The auditor should examine whether the aggregate balances comprising this item as shown in the relevant register tally with the control accounts as per the general ledger. He should also examine subsequent repayments received from borrowing banks to verify the amounts shown under this head as at the year-end. It may be noted that call loans made by a bank cannot be netted off against call loans received.

Like deposits with banks, moneys at call and short notice are also usually (though not necessarily) in round figures. Any odd balances should, therefore, put the auditor to enquiry.

The auditor should also examine that money market lending's for more than 6 days are not classified under this head, but are classified as 'deposits' or 'advances', depending on the nature of lending and the parties to whom the moneys have been lent.

It may be noted that as per the directions of the RBI, banks cannot pay any brokerage on deposit and call loans, except to the extent specified in paragraph 8(e) of the RBI circular dated July 22, 1974.

The auditor should examine whether interest has been properly accrued and accounted for on year-end outstanding balances of money at call and short notice.

Nostro & Vostro Accounts :

NOSTRO ACCOUNT : Bank maintains stock of foreign currencies in the form of bank account with their overseas branches. These accounts are called as NOSTRO Account. The auditor should obtain & examine the reconciliation statement between Indian Branch and overseas Branch, Un reconciled nostro account indicates unauthorized payments, unauthorized withdrawals and unauthorized debits to minor accounts. The auditor should also evaluate interal control regarding inward and outward messages. Any discrepancy should be properly dealt with. The auditor should check the confirmation certificate received from the overseas branch.

VOSTRO ACCOUNT : This is opposite of Nostro Account. A foreign bank in another country maintains stock of Indian rupees with its Indian correspondent bank. The auditor should audit this on the same lines with Nostro Accounts.

11. Investments

Banks are required to classify their entire investments portfolio into three categories: held-to-maturity, available-for-sale and held-for-trading.

(i) Held-to-maturity (HTM)

This category would comprise securities acquired by the bank with the intention to hold them up to maturity.

(ii) Held-for-trading (HFT)

This category would comprise securities acquired by the bank with the intention of trading, i.e. to benefit from short-term price/interest rate movements.

(iii) Available-for-sale (AFS)

This category will comprise securities, which to not qualify for being categorised in either of the above categories. i.e., those that are acquired neither for trading purpose nor for being held till maturity.

The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Examination of compliance with statutory and regulatory requirements is also an important objective in audit of investment in as much as non-compliance may have a direct and material effect on the financial statements. The latter aspect assumes special significance in the case of banks where investment transactions have to be carried out within the numerous parameters laid down by the relevant legislation have to be carried out within the numerous parameters laid down by the relevant legislation and directions of the RBI. The auditor should keep this in view while designing his audit procedures relating to investments.

Internal Control Evaluation and Review of Investment Policy

The auditor should familiarise himself with the instructions issued by the RBI regarding transactions in securities. He should review the investment policy of the bank to ascertain that the policy conforms, in all material respects, to the RBI's guidelines as well as to any statutory provisions applicable to the bank. While examining the internal controls over investments (including those on SGL forms and BRs), the auditor should particularly also judge their efficacy. The auditor should satisfy himself that investments made by the bank are in accordance with the laid down investment policy. A review of the reports on concurrent audit of treasury transactions and follow-up action taken by the management thereon may be useful to the auditor. The auditor should also review the half yearly review of portfolio by the Board of the bank and also review inspection report of the RBI carried out under Section 35 of the Act.

Examination of Reconciliation

The auditor should examine the reconciliation of the investment account, physically verify the securities on hand, obtain confirmations of SGL balances with the PDO, and examine the control and reconciliation of BRs issued by the bank. Needless to add, the actual control and reconciliations etc., are to be carried out by the bank's management; however, the auditor should examine the same.

Examination of Documents

The auditor should examine whether the legal requirements governing the bank, in so far as they relate to investments, have been complied with and the investments made by the bank are not ultra virus the bank.

The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker’s contract note, bill of costs, receipts and other similar evidence. The auditor should pay special attention to ascertaining whether the investments have been purchased or sold cum-dividend/ex-dividend, cum-interest/ex-interest, cum-right/ex-right, or cum-bonus/ex-bonus. He should check whether appropriate adjustments in this regard have been made in the cost/sales value of securities purchased or sold.

The auditor should satisfy himself that In the case of a right issue and as regards bonus shares. appropriate care is taken by the bank.

Physical Verification

The auditor should verify the investment scrips physically at the close of business on the date of the balance sheet. In exceptional cases where physical verification of investment scrips on the balance sheet date is not possible, the auditor should carry out the physical verification on a date as near to the balance sheet date as possible.

12. Advance

Amounts disclosed in the balance sheet under the head ‘advances’ comprise-

(a) Money lent by the bank to its customers and interest accrued and due there on {net of amount shown in (d)};

(b) Debit balances in deposit accounts;

(c) Amount of participation on risk-sharing basis under inter-bank participation schemes in capacity as a participating bank; and

The amount to be included here is net of the amount allotted to other banks under inter-bank participation schemes on risk-sharing basis

(d) Amount receivable from Government of India under the Agricultural Debt Waiver Scheme 2008.

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 advnces are outstanding at the date of the balance sheet.

b. Advances represent amount due to the bank.

c. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.

d. There are no unrecorded advances.

e. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognized in their valuation.

f. The advances are disclosed, classified and described in accordance with recognized 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 in insignificant. The extent of sample checking would also depend on the auditor’s assessment of efficacy of internal controls. As a general rule, however, an advance may be considered to be a large advance if the year-end balance is in excess of Rs. 2 crore or 5% of the aggregate year-end advances of the branch, whichever is less.

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. The sanction for an advance should specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment etc. It also needs to be ensured that the loans sanctioned are as per the Loan Policy of the bank and adhere to the regulatory (RBI) norms unless a specific exemption is taken in this regard.

- 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.

- It 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.

Classification of Advances

The guidelines require banks to classify their advances into four broad categories for the purpose of provisioning as follows.

(a) Standard assets

A standard asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset is not a non-performing asset.

(b) Sub-standard assets

With effect from March 31, 2005, a sub-standard asset is one which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower / guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the bank in full.

(c) Doubtful assets

With effect from March 31, 2005, an asset is classified as doubtful if it has remained in the sub-standard category for a period of 12 months. Such an asset has all the inherent weaknesses as in a doubtful asset and an added characteristic that the weaknesses make the collection or liquidation in full highly improbable or questionable.

(d) Loss assets

A loss asset is one where loss been identified by:

(a) The bank; or
(b) The internal or external auditors; or
(c) The RBI inspection, but the amount has not been written off fully.

Non-Performing Assets

Under the guidelines, income recognition, and provisioning in respect of a credit facility are based on its status of classification as performing or non-performing. A credit facility becomes non-performing "when it ceases to generate income for a bank". Detailed guidelines have been laid down for determining the status of different kinds of credit facilities (term loans, cash credits and overdrafts, bills purchased and discounted, and other credit facilities) as performing or non-performing. These are discussed below.

Criteria for Classification of Various Types of Credit Facilities

In line with the international best practices and to ensure greater transparency, the RBI has directed the banks to adopt the

’90 days’ overdue norm for identification of NPAs from the year ending March 31, 2004.

Banks have been charging interest at monthly rests, form April 1, 2002. However, the banks were advised that the date of classification of an advance as NPA would not be changed on account of charging of interest at monthly rests. Banks should, therefore, continue to classify an account as NPA only if the interest charged during any quarter is not serviced fully within 90 days from the end of the quarter.

An account should be treated as ‘out of order’ if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. 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 not enough to cover the interest debited during the same period, these accounts should be treated as ‘out of order’. Further, 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.

The following criteria are to be applied for determining the status of various types of credit facilities:

a) Term Loans: A term loan is treated as non-performing asset (NPA) if interest and/or instalment of principal remain overdue for a period of more than 90 days.

b) Cash Credits and Overdrafts : A cash credit or overdraft account is treated as NPA if it remains out of order as indicated above.

c) Bills Purchased and Discounted : Bill purchased and discounted are treated as NPA if they remain out of order as indicated above.

d) Securitisation: The asset is to be treated as NPA if the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitization transaction undertaken in terms of guidelines on securitization dated February 1, 2006.

13. Fixed Assets

Fixed assets comprise premises and other fixed assets such as furniture and fixtures, motor vehicles, office equipment’s computers, etc.

In carrying out the audit of fixed assets, the auditor is concerned, primarily, with obtaining evidence about their existence and valuation. For this purpose, the auditor should review the system of internal controls relating to fixed assets, particularly the following:

- Control over expenditures incurred on fixed assets acquired or self-constructed;
- Accountability and utilisation controls; and
- Information controls for ensuring availability of reliable information about fixed asses.

The branch auditor should ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally, Similarly, he should ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. The procedures described in the following paragraphs would be relevant only to the extent the accounts and documents of title, etc., of fixed assets take place at branches / other officers, but accounting of fixed assets is done at the head office, the branch auditor should examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office.

Premises

The auditor should verify the opening balance of premises with reference to schedule of fixed assets, ledger or fixed assets register. Acquisition of new premises should be verified with reference to authorisation, title deeds, record of payment, etc. Self-constructed fixed assets should be verified with reference to authorization and documents such as, contractors' bills, work order records and record of payments. The auditor should also examine whether the balances as per the fixed assets register reconcile with those as per the ledger and the final statements.

In the case of leasehold premises, capitalisation and amortisation of lease premium, if any, should be examined. Any improvements to leasehold premises should be amortized over their balance residual life.

In case the title deeds are held at the head office or some other location, the branch auditor should obtain a written representation to this effect from the branch management and should bring this fact to the notice of the central statutory auditor through a suitable mention in his report. This fact should also be brought in the Long Form Audit Report (LFAR).

Where premises are under construction, it should be seen that they are shown under a separate heading, e.g. ‘premises under construction’. Advances to contractors may be shown as a separate item under the head ‘fixed assets’ or under the head ‘other assets’. It should be ensured that where the branch has obtained the licence to commence business and is ready for use then the same is not shown as “premises under construction”. In such cases even if all the bills/documents from the contractors/suppliers are not received, at the year end, an estimate of the expenditure thereon should be made and capitalised on a provisional basis.

Where the premises (or any other fixed assets) are re-valued, the auditor should examine the appropriateness of the basis of revaluation. The auditor should also examine whether the treatment of resultant revaluation surplus or deficit is in accordance with Accounting Standard (AS) 10, “Accounting for Fixed Assets”1. The auditor should also check the impairment, if any, by applying the principles laid down in Accounting Standard (AS) 28, “Impairment of Assets”.

The auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, howsoever acquired (i.e. whether acquired by way of satisfaction of claims or otherwise), for a period exceeding seven years from the date of acquisition, except such as is required for its own use. The auditor should specifically examine that no immovable properties other than those required for the own use of the bank have been included in fixed assets (own use would cover use by employees of the bank, e.g. residential premises provided to employees). The branch auditor should also obtain a written representation to the above effect from the branch management.

Other Fixed Assets

The procedures discussed above regarding premises also apply, to the extent relevant, to verification of other fixed assets. In respect of moveable fixed assets, the auditor should pay particular attention to the system of recording the movements as well as other controls over such fixed assets.

14. Other Assets

The following items broadly are to be disclosed under the head ‘Other Assets’:

- Inter-office adjustments (net)
- Interest accrued

- Tax paid in advance/tax deducted at source
- Stationery and stamps
- Non-banking assets acquired in satisfaction of claims
- Others

As per RBI circular credit card outstanding is not to be included under 'Other Assets'. Instead, they have to be shown as part of advances.

Other Assets

The branch auditor may carry out the audit of various items appearing under the head 'other assets' in the following manner.

15. Inter-Office Adjustments

The balance in the inter-branch accounts, if in debit, is to be shown under this head. The inter-branch accounts are generally sub-divided into segment or specific areas, e.g., 'Demand Drafts Paid', 'Inter-branch Remittances', 'Head Office Account', etc. The net aggregate of all such accounts should be shown under this head.

16. Interest Accrued

The main components of this item are interest accrued but not due on investments and advances and interest due but not collected on investments. As banks normally debit the borrower's account with interest due on the balance sheet date, there would not usually be any amount of interest accrued but not due on advances On the other hand interest on government securities, debentures, bonds, etc. which accrues from day to day should be calculated and brought into account, in so far as it has accrued on the date of the balance sheet. The auditor should examine this item in the usual manner, i.e., by reference to terms of payment of interest, rate of interest, period elapsed till the date of balance sheet, etc.

The auditor should ensure that only such interest as can be realized in the ordinary course of business should be shown under this head. This is based on the principle, recognized in AS 9, that revenue cannot be recognized if there is a significant uncertainty about its collectability. Dividends recognized as income but not received may be included in the residuary sub-head of 'others'. Dividends and interest on investments would be recognized in the books of the branch only if it is handling the work relating to investments or receipt of income on investments.

17. Tax Paid in Advance/Tax Deducted at Source

Generally, this item is dealt with at the head office level only and would, therefore, not appear in the balance sheet of a branch, except that tax deducted at source on fixed deposits and other products/services is handled at the branch level. The procedures to be followed by the branch auditor for verification of tax deducted at source by the branch would be similar to those in an audit of other types of entities. The branch auditor needs to ensure that the certificates for such tax deducted at source is collected by the branch and the original copy is sent to the Head Office along with the transfer of such Tax Deducted at Source (TDS) amount to Head Office on periodic basis as defined.

At Head Office level, the availability of all the TDS Certificates, submission of the same with Income Tax Department/Claim of the same in Income Tax returns filed should be checked to ensure the justification of the claim towards such certificates.

18. Stationary and Stamps

Internal controls over stationery of security items (like term deposit receipts, drafts, pay order, cheque books, traveler's cheques, gift cheques, etc.) assume special significance in the case of banks as their loss or misuse could eventually lead to a misappropriation of the most valuable physical asset of a bank, viz., cash. The branch auditor should study and evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of his audit. It may be noted that the branch auditor is required to specifically comment on the adequacy of the relevant internal controls in his LFAR.

The item "Stationery and Stamps" should include only exceptional items of expenditure on stationary like, bulk purchase of security paper, loose leaf or other ledgers, etc., which are shown as quasi-asset to be written off over a period of time. In other words, the normal expenditure on stationary may be treated as an expense in the profit and loss account, while unusually heavy expenditure may be treated as an asset to be written off based on issue/consumption. At the branch level, the expenditure on latter category may not appear since a considerable part of the stationery is supplied to branches by the head office.

The auditor should physically verify the stationery and stamps on hand as at the year-end, especially stationery of security items. Any shortage should be inquired into as it could expose the bank to a potential loss from misuse. The auditor should examine whether the cost of stationery and stamps consumed during the year has been properly charged to the profit and loss account for the year in the context of the accounting policy/instructions from the head office regarding treatment of cost of stationery and stamps.

19. Non-Banking Assets Acquired in Satisfaction of Claims

Under this heading, will be included, those immovable properties/tangible assets, which the bank has acquired in satisfaction of debts due or its other claims and are being held with the intention of being disposed of.

While examining this item, the auditor should specifically keep in mind the provisions of Section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, however, acquired (i.e. whether acquired by the of satisfaction of claims or otherwise), except such as is required for its own use, for any period exceeding seven years from te date of acquisition thereof. During this period, the bank may deal or trade in any such property for the purpose of facilitating the disposal thereof. The RBI has the power to extend the aforesaid period in a particular case up to another five years. (it may be noted that the aforesaid section is applicable to banking companies only and not to other types of banks like nationalized banks).

Except when held for its own use, AS 10, “Accounting for Fixed Assets” would not be applicable on those fixed assets which are held with the bank in satisfaction of claim. At the data of acquisition, the assets should be recorded at amount lower of the net book value of the advance or net realizable value of asset acquired. At each balance sheet date, net realizable value of such assets may be re-assessed and necessary adjustment may be made. The auditor should verify such assets with reference to the relevant documentary evidence, e.g., terms of settlement with the party, order of the Court or the award of arbitration, etc. he should satisfy himself that the ownership of the property has legally vested in the bank. If there is any dispute or other claim about the property, the auditor should examine whether the recording of the asset is appropriate or not. Incase the dispute arises subsequently, the auditor should examine whether a provision for liability or disclosure of a contingent liability is appropriate, keeping in view the requirements of AS 29 Provisions.

20. Others

This is the residual heading, which will include items not specifically covered under othe sub-heads e.g., claims which have nt been received, debit items representing additions to assets or reductions in liabilities which have not been adjusted for technical reasons or want of particulars, etc., receivables on account of government business, prepaid expenses, accrued income other than interest (e.g., dividend declared but not received) may also be included under this head. The audit procedure relating to some of the major items included under this head are discussed below.

21. Contingent Liabilities

In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. To this end, the auditor should, generally follow the audit procedures give below:

(a) The auditor should ensure that there exists a system whereby the non fund based facilities or additional/ad hoc credit facilities to parties are extended only to their regular constituents, etc.

(b) Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorized to do so and in accordance with the laid down procedures.

(c) The auditor should also ensure that in case of LCs for import of goods, as required by the above mentioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.

(d) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded.

(e) Perform substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.

(f) Review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.

(g) Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.

(h) Obtain representation from the management that

(i) all contingent liabilities have been disclosed;

(ii) the disclosed contingent liabilities do not include any contingencies which are likely to result in a loss/expense and which, therefore, require creation of a provision in the financial statements.

(iii) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of

Accounting Standard 29, including any possibility of any reimbursement;

(iv) in case of guarantees issued on behalf of the bank's directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advance to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of section 20 of the Banking Regulations Act, 1949 has arisen on account of such guarantee; and

(v) such contingent liabilities which have not been disclosed on account of the fact that the possibility of their outcome is remote, include the management's justification for reaching such decision in respect of those contingent liabilities.

(i) The auditor should also examine whether the bank has given any guarantees in respect of any credit (buyer's credit or seller's credit)*. The period of guarantees is co-terminus with the period of credit reckoned from the date the shipment.

(j) Verify whether bank has extended any non-fund facility or additional/ad hoc credit facilities to other than its regular customers. In such cases, auditor should ensure concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers.

The specific procedures to be employed by the auditor to verify various items of contingent liabilities are discussed in the following paragraphs. It may be noted that many of the items discussed in the following paragraphs, may be designated in foreign currencies.

22. Claims against the Bank Not Acknowledged as Debts

The auditor should examine the relevant evidence, e.g., correspondence with lawyers/other, claimants, workers/officers, and workmen's/officers' unions. The auditor should also review the minutes of meetings of board of directors/committees of board of directors, contracts, agreements and arrangements, list of pending legal cases, and correspondence relating to taxes, and duties, etc. to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of the year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

23. Liability of Account of Outstanding Forward Exchange Contracts

The auditor may verify the outstanding forward exchange contracts with the register maintained by the branch and with the broker's advice notes. In particular, the net "position" of the branch in relation to each foreign currency should be examined to see that position is generally squared and not uncovered by a substantial amount. The net "position" as reported in the financial statements may be verified with reference to the foreign exchange position report prepared by the back office.

24. Guarantees Given on Behalf of Constituents

The auditor should ascertain whether there are adequate internal controls over issuance of guarantees, e.g., whether guarantees are issued under proper sanctions, whether adherence to limits sanctioned for guarantees is ensured, whether margins are taken from customer before issuance of guarantees as per the prescribed procedures, etc.

The auditor should ascertain whether there are adequate controls over unused guarantee forms, e.g., whether these are kept under the custody of a responsible official, whether a proper record is kept of forms issued, whether stock of forms are periodically verified and reconciled with the book records, etc.

The auditor should examine the guarantee register to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not.

The auditor should check the relevant guarantee registers with the list of outstanding guarantees to obtain assurance that all outstanding guarantees are included in the amount disclosed in this behalf. The auditor should also examine that expired guarantees are not included in this head. He should verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. He should also verify the securities held as margin. If a claim has arisen, the auditor should consider whether a provision is required in terms of the requirements of AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

The auditor should obtain a written confirmation from the management that all obligations in respect of guarantees have been duly recorded and that there are no guarantees issued up to the year end-end which are yet to be recorded.

25. Acceptances, Endorsements and Other Obligations

The auditor should evaluate the adequacy of internal controls over issuance of letters of credit and over custody of unused LC forms in the same manner as in the case of guarantees. The auditor should verify the balance of letters of credit from the register maintained by the bank. The register indicates the amount of the letters of credits and payments made under them. The auditor may examine the guarantees of the customers and copies of the letters of credit issued. The security obtained for issuing letters of credit should also be verified.

26. Other Acceptances and Endorsements

The auditor study the arrangements made by the bank with its customers. He should test check the amounts of the bills with the register maintained by the bank for such bills. The auditor should also examine whether such bills are marked off in the register on payment at the time of maturity.

In respect of letters of comfort, the auditor should examine whether the bank has incurred a potential financial obligation under such a letter. If a comfort letter does not cast any such obligation on the bank, no contingent liability need to be disclosed on this account.

Common Procedures

The auditor should obtain a written confirmation from the management that all obligation assumed by way of acceptances, endorsements and letters of credit have been duly recorded and there are no such obligations assumed up to the year-end, which are yet to be recorded.

The auditor should ascertain whether a contingent obligation assumed by a bank either by way of acceptance, endorsement etc. has resulted in an actual obligation owing to any act or default on the part of its constituent. In such a case, a provision would have to be made in the accounts for the bank's obligation. The amount of the provision should be determined taking into account the probable recovery from the customer.

27. Other Items for which the Bank is Contingently Liable

The auditor should examine whether commitments under all outstanding underwriting contracts have been disclosed as contingent liabilities. For this purpose, the auditor should examine the terms and conditions of the relevant contracts.

Rediscounting is generally done with the RBI, Industrial Development Bank of India or other financial institutions or, in the case of foreign bills with foreign banks. If the drawer dishonors the bill, the rediscounting bank has a right to proceed against the bank as an endorse of the bill. The auditor may check this item from the register of bills rediscounted maintained by the branch. He should satisfy himself that all the bills are properly market off on payment at the time of maturity.

In respect of disputed tax demands, the auditor should examine whether there is a positive evidence or action on the part of the bank to show that it has not accepted the demand for payment of tax of duty. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where demand notice/intimation for the payment of tax is for a certain amount and the dispute related to only a part and not the whole of the amount, only such should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure as per provisions of AS 29, "Provisions, Contingent Liabilities and Contingent Assets". In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of meeting of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

Disputed tax liabilities in respect of income-tax and similar central taxes would not form part of balance sheet of a branch as these items are dealt with at the head office level. However, the principles enunciated above should be followed in dealing with taxes and duties (such as, local taxes) dealt with at the branch level.

The auditor should also look into the manner of disclosure of interest rate swaps in the financial statements of the bank. The interest rate swaps would be treated as real or contingent liability depending upon the facts and circumstances of each case in accordance with the provisions of the Accounting Standard (AS) 29.

The auditor as in the case of other entities may verify other items under this head.

28. Bills for Collection

The auditor should ensure that the bills drawn on other branches of the bank are not included in bills for collection.

Inward bills are generally available with the bank on the closing day and the auditor may inspect them at that time. The bank dispatches outward bills for collection soon after they are received. They are, therefore, not likely to be in hand at the balance sheet. The auditor may verify them with reference to the register maintained for outward bills for collection.

The auditor should also examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection.

In regard to 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 accordance with the nature of obligation of the bank in respect of bills for collection.

The commission of the branch becomes due only when the bill has been collected. The auditor should, accordingly, examine that there exists adequate internal control system that debits the customer's account with the amount of bank's commission as soon as a bill collected is credited to the customer's account. The auditor should also examine that no income has been accrued in the accounts in respect of bills outstanding on the balance sheet date.

29. Co-acceptance of Bills

The auditor should ensure that the bank has instituted an adequate internal control system to comply with the safeguards as set out by the RBI's Master Circular on Guarantees and Co-acceptances.

PROFIT & LOSS ACCOUNT

30. Income

In carrying out an audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transaction, which took place during the relevant period and pertain to the bank, that there is no unrecorded income, and that income is recorded in proper amounts and is allocated to the proper period. In view of the mandatory requirement of recognition of income, the recognition of revenue will have to be subjected to examination vis-à-vis the guidelines.

31. Interest Income

As a measure of control and also to ensure that the legal remedies against defaulting borrowers are not adversely affected, banks commonly follow the procedure of recording interest on non-performing advances in separate account styled as 'Interest Suspense' or other similar account. Amounts lying in Interest Suspense Account do not represent income of the bank and have also to be deducted from the relevant advances. The auditor should also check whether, in terms of the income recognition guidelines issued by the RBI, the bank has either reversed or made provision in respect of interest accrued and credited to income account, in respect of an advance (including bills purchased and discounted) that becomes NPA as at the close of any year.

In case of accounts under Corporate Debt Restructuring (CDR) scheme, the auditor should see whether the income on projects under implementation which have been classified as standard has been accounted for on accrual basis pursuant to the RBI's income recognition norms. Banks are not permitted to recognize income on accrual basis from projects under implementation which have been classified as 'sub-standard' asset. Bank may recognize income in such accounts only on realization on cash basis.

Income in respect of Funded Interest and where loans are converted into Equity, debentures or any other instrument is to be recognized on the same basis as in the case of Restructuring and Reschedulement of loans.

The said norms also require that the banks should not recognize income from those projects under implementation which have been classified as substandard should be recognized only on cash basis. The auditor should also, accordingly, see whether any interest on such projects which has been recognized as income in the past is either reversed or a provision for an equivalent amount is made in the accounts.

As per Accounting Standard (AS) 9, "Revenue Recognition", income is recognized 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 view of the significant uncertainty regarding ultimate collection of Income arising in respect of NPA, banks should not recognize interest on NPA until it is actually received. Further, recognition of interest should be deferred where there is uncertainty regarding its collection.

These norms are also applicable to all Government guaranteed accounts i.e., if Government guaranteed advances become NPA, interest on such advances should not be taken to income account unless interest has been realized.

The auditor should, on a sample basis, check the rates of interest, etc. (with sanctions and agreements) as well as the calculation of interest to satisfy himself that-

(a) Interest has been charged on all the performing accounts up to date of the balance sheet

(b) Interest rates charged are in accordance with the banks internal regulation, directives of the RBI and agreements with the respective borrowers. The scrutiny of interest rates charged is particularly important in the case of advances made on floating interest rate basis.

(c) Discount on bills outstanding on the date of the balance sheet has been properly apportioned between the current year and the following year.

(d) Interest on inter-branch balances has been provided at the rates prescribed by the head office; and

(e) Any interest subsidy received (or receivable) from RBI in respect of advances made at concessional rates of interest is correctly computed.

The auditor should also satisfy himself that interest on non-performing assets has not been recognized unless realized.

Dividends received should be checked with reference to counterfoils of dividend warrants. As per AS 9, “Reserve Recognition”, dividends should be recognized when the right to receive payment is established, i.e. dividend has been declared by the corporate body at its Annual General Meeting and the owner’s right to receive payment is established.

In determining the extent of sample checking, the auditor should take into account, inter alia, the results of the analytical procedures and the reports, if any, on income and expenditure/revenue audit as well as other internal and RBI inspection reports. The auditor’s assessment of the effectiveness of concurrent audit would also affect the extent of his detailed checking of interest earned. In determining the extent of sample checking, the auditor may place greater emphasis on examining interest on large advances.

The auditor may check the items of commission, exchange and brokerage on a test basis. The auditor should examine whether the commission on non-funded business (e.g. letters of credit, guarantees and bills for collection) has been properly apportioned between the current year and the following year.

The auditor should also check whether any fees of commission earned by the banks as a result of re-negotiations or rescheduling of outstanding debts has, in terms of the income recognized on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

According to the guidelines for income recognition, asset classification, etc., issued by the RBI, if interest income from assets in respect of a borrower becomes subject to non-accrual, fees, commission and similar income with respect to same borrower that have been accrued should cease to accrue for the current period and should be reversed or provided for with respect to past periods, if uncollected. The auditor should examine whether the bank has accordingly made suitable adjustments for de-recognition/reversal of uncollected commission, etc.

Profit on Sale of Investments: Investments are dealt in the course of banking activity and hence the profit & loss in sale of investments are taken to profit & loss account. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

Profit/Loss on Revaluation of Investments: In terms of guidelines issued by RBI investments are to be valued at periodical intervals and depreciation or appreciation in valuation is to be recognized under this head. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

The auditor can check authority for disposal fixed assets, if any, sold during the year under audit; and non-banking assets acquired in satisfaction of claims.

The auditor should also vouch transactions in evidence of profit/loss recorded by the Branch in respect of assets, as aforesaid.

32. Profit/Loss on Re-valuation of Fixed Assets

The auditor should satisfy himself about the appropriateness and proper application of the basis of revaluation of fixed assets adopted by the bank. Where revaluation is based on an appraisal by approved values, the auditor should examine the appraisals to the extent possible and satisfy himself about their adequacy for audit purposes.

The revaluation of fixed assets can be done on the basis of appraisals by competent valuers such as engineers or architects, or on the basis of indexation of historical cost, or with reference to current proces. The auditor should satisfy himself about the appropriateness and proper application of basis of valuation adopted by the bank. Where revaluation is based on an appraisal by valuers, the auditor should examine the appraisals to the extent possible and satisfy himself about their adequacy for audit purposes.

The auditor should also examine that the bank has complied with the provisions of AS 28, Impairment of Assets. In terms of paragraph 58 of AS 28, an impairment loss should be immediately recognized as an expense in the Profit and Loss Account immediately, unless the asset is carried at revalued amount im accordance with AS 10. In such a case, any impairment loss of a revalued asset should be treated as a revaluation decrease under AS 10.

The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

EXPENDTURE:

33. Interest Extended

The auditor may assess the overall reasonableness of the figure of interest expense by working out the ratio of interest on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. For example, the auditor may 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 may also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyses any material differences.

The auditor should, on a sample basis, check the calculation of interest. He should satisfy himself that-

(a) Interest has been provided on all deposits and borrowings up to the date of the balance sheet; and verify whether there is any excess or short credit of material amount.

(b) Interest rates are in accordance with the bank's internal regulations, of the R B I directives and agreements with the respective depositors.

(c) In case of Fixed Deposits it should be ensured that the Interest Rate in the accounting system are in accordance with the Interest Rate mentioned in the Fixed Deposit Receipt/Certificate.

d) Interest on Savings Account should be checked on a sample basis in accordance with the rules framed by the bank in this behalf.

e) Discount on bills outstanding on the date of the balance sheet has been properly apportioned between the current year and the following year.

f) Payment of brokerage is properly authorized; and
g) Interest on inter-branch balances has been provided at the rates prescribed by the head office.

h) Interest on overdue/matured term deposits should be estimated and provided for.

34. Operating Expenses

Generally the audit procedures followed by auditors in any entity are to be followed. Payments to and Provisions for Employees. The auditor should ascertain the procedure followed by the bank in this regard while verifying this item.

The auditor should check the calculation of salaries and allowances, etc. on a sample basis with reference to relevant agreements/awards. He may also assess the reasonableness of expenditure on salaries, allowances, etc. by working out their ratio to total operation expenses and comparing it with the corresponding figures for previous years.

Rent, Taxes and Lighting

The auditor may check the following on a sample basis:

- Rent paid and verifies whether adjustments have been made for the full year on account of rent at the rates as applicable and as per agreement in force.
- Rent does not include House Rent Allowance to employees.
- Whether municipal rates/taxes are duly paid/adjusted for the year under audit.
- Enquire whether any disputed liability exists on this account upto the year end.

Printing and Stationery

The auditor should accordingly verify this item with reference to documents evidencing purchase/debit note received.

Advertisement and Publicity

Expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material is verified with the documents.

Depreciation on Bank's Property

The auditor should ascertain the exact procedure followed by the bank while verifying this item.

This item includes depreciation on bank's own property, motor cars and other vehicles, electrical fittings, vaults, lifts, leasehold properties, non-banking assets, etc, Depending on the procedure followed in the bank, provision for depreciation may either be centralized at the head office level or decentralized.

The auditor should check Head Office instructions as regards adjustments of depreciation on the fixed assets of the Branch.

The auditor should also check whether depreciation on fixed assets has been adjusted at the rates and in the manner required by H.O.

The auditor may also report unadjusted depreciation on assest acquired but not capitalised.

The auditor should ascertain the exact procedure followed by the bank while verifying this item.

i) Directors' Fees, Allowances and Expenses : Expenditure incurred in this regard are recorded under this head. This item is dealt with at the head office level and would not therefore be relevant at the branch level.

ii) Auditors' Fees and Expenses : Remuneration payable to Statutory Auditors and Branch auditors and expenses in connection with audit like reimbursements are recognized under this head. This item is usually dealt with at the head office level and would not therefore be relevant at the branch level.

iii) Law Charges : All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here. Auditors should verify the legal charges payable by the bank in respect of all legal disputes/cases currently being fought at various courts of laws, etc. are accounted for in the accounts. For this purpose, the auditor may go through the list of contingent liabilities prepared by the bank as at the year end to verify the disputes/cases which the bank is contesting.

iv) Postage Telegrams, Telephones, etc : This item includes all postal charges like stamps, telegrams, telephones, tele-printers, etc.

v) Repairs and Maintenance : This item includes repairs to bank's property, their maintenance charges, etc.

vi) Insurance : This item is usually dealt with at the head office level and may not therefore be relevant at the branch level.

vii) Other Expenditure : This item includes all expenses other than those included in any of the other heads, like, licence fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any particular item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

35. Provisions and Contingencies

Provisions in respect of NPA and NPI should be verified with the regulatory requirements to ensure full provisioning. The other provisions for expenditure, taxes, etc. are to be examined with the circumstances warranting the provisioning and the adequacy of the same.

36. Audit of Branches

Audit of branches of banking companies is required under section 228 of the Companies Act, 1959. It is thus obligatory for a banking company to get the financial statements of each of its branch offices audited except where exemption from audit is obtained in respect of certain branches under the Companies (Branch Audit Exemption) Rules, 1961 and as per the guidelines of the RBI issued from time to time.

The branch auditor has the same powers and duties in respect of audit of financial statements of the branch as those of the central auditors in relation to audit of head office. The branch auditor's report on the financial statements examined by him is forwarded to the central auditors with a copy to the financial statements examined by him is forwarded to the central auditors with a copy to the management of the bank. The branch auditor of a public sector bank, private sector bank or foreign bank is also required to furnish a long form audit report to the bank management and to send a copy thereof to the central auditors. The central auditors, in preparing their report on the financial statements of the bank, deal with the branch audit reports in such manner as they consider necessary.

37. Internal Audit

The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operating. Banks generally have a well-organised system of internal audit. The internal audit is carried out either by a separate department within the bank or by independent firms of chartered accountants. Apart from these, the inspectors of RBI also review the system and transactions of important branches.

RBI has advised banks to adopt a framework for Risk-Based Internal Audit to ensure that the internal audit is undertaken in the bank in a risk focused manner. This would also facilitate in adoption of the Risk-based Supervision framework.

38. Revenue Audit

Revenue audit is usually conducted at large and medium-sized branches and is aimed at identifying cases of leakage of revenue due to wrong computation of interest, non-application of interest on time, application of incorrect rates of interest/ exchange/ commission, non-application of penal interest, non-recovery or short-recovery of service charges on guarantees and letters of credit, etc. This type of audit is also know as 'income and expenditure audit' or 'income leakage audit'.

39. Concurrent Audit

A system of concurrent audit at large and other selected branches has been in vogue in most of the banks for quite long. Recognizing the importance of concurrent audit in the banking sector, the RBI, vide its circular no. BC.82/16.13.100/93-94 dated October 11, 1993, addressed to all scheduled commercial banks (except regional rural banks) formally advised such banks to institute an appropriate system of concurrent audit.

12.8 THE THIRD SCHEDULE TO THE BANKING REGULATION ACT, 1949

The Third Schedule
To the Banking Regulation Act, 1949
(See Section 29)
FORM 'A'
Form of Balance Sheet

Balance Sheet of______________ (here enter name of the Banking Company) Balance Sheet as on 31st March-(Year) (000's omitted)

	Schedule	*As on 31.3____ (current year)*	*As on 3.3____ (previous year)*
Capital & Liabilities			
Capital	1		
Reserves & Surplus	2		
Deposits	3		
Borrowings	4		
Other liabilities and provisions	5		
Total			

Assets			
Cash and Balances with Reserve Bank of India	6		
Balances with banks and money at call and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11		
Total			
Contingent Liabilities Bill for Collection	12		

Schedule I
Capital

	As on 31.3___ (current year)	As on 31.3___ (previous year)
I. ***For Nationalised Banks*** Capital (Fully owned by Central Government)		
II. ***For Banks Incorporated Outside India*** Capital (The amount brought in by banks by way of start-up capital as prescribed by RBi should be shown under this head.) Amount of deposit kept with RBI under section 1(2) of the Banking Regulation Act, 1949.		
Total		
III. **For Other Banks** Authorised Capital (. . . . . . .shares of Rs.. . . each) Issued Capital (. . . . . . .shares of Rs.. . . each) Subscribed Capital (. . . . . . .shares of Rs.. . . each) Called-up Capital (. . . . . . .shares of Rs.. . . each) *Less:* Calls unpaid *Add:* Forfeited shares		
Total		

Schedule 2 Reserves & Surplus		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
I. ***Statutory Reserves*** Opening Balances Additions during the year Deductions during the year		
II. ***Capital Reserves*** Opening Balances Additions during the year Deductions during the year		
III. ***Share Premium*** Opening Balances Additions during the year Deductions during the year		
IV. ***Reserves and Other Reserves*** Opening Balances Additions during the year Deductions during the year		
V. ***Balance in Profit and Loss Account***		
Total (I, II, III,IV and V)		

Schedule 3 Deposits		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
A. I. ***Demand Deposits*** i) From banks ii) From others		
II. ***Savings Bank Deposits***		
III. ***Term Deposits*** i) From banks ii) From others		
Total (I, II, and III)		
B. i) Deposits of branches in India ii) Deposits of branches outside India		
Total		

Schedule 4 Borrowings		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
I. ***Borrowings in India*** i) Reserve Bank of India ii) Other banks iii) Other institutions and agencies		
II. ***Borrowings outside India***		
Total (I and II)		
Secured borrowings included in I & II above-Rs.		

Schedule 5 Other Liabilities and Provisions		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
I. Bills payable		
II. Inter-office adjustments(net)		
III. Interest accrued		
IV. Others (including provisions)		
Total		

Schedule 6 Cash and Balances with Reserve Bank of India		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
I. ***Cash in hand*** (including foreign currency notes)		
II. ***Balances with Reserve Bank of India*** (i) in Current Account (ii) in Other Account		
Total (I & II)		

Schedule 7 Balances with Banks and Money at Call & Short Notice		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
I. ***In India*** (i) Balances with banks (a) in current account (b) in other deposit accounts (ii) Money at call and short notice (a) with banks (b) with other institutions		
Total (i & ii)		
II. ***Outside India*** (i) in current accounts (ii) in other deposit accounts (iii) Money at call and short notice		
Total		
Grand Total (I & II)		

Schedule 8 Investments		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
I. ***Investments in India in*** i) Government securities ii) Other approved securities iii) Shares iv) Debentures and bonds v) Subsidiaries and/or joint ventures vi) Others (to be specified)		
Total		
I. ***Investments Outside India in*** i) Government securities (including local authorities) ii) Subsidiaries and/or joint ventures abroad iii) Other investments (to be specified)		
Total		
Grand Total (I & II)		

Schedule 9 Advances		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
A. (i) Bills purchased and discounted (ii) Cash credits, overdrafts and loans repayable on demand (iii) Term loans		
Total		
B. (i) Secured by tangible assests (ii) Covered by bank/Government guarantees (iii) Unsecured		
Total		
C. (I) Advances in India i) Priority sectors ii) Public sector iii) Banks iv) Others		
Total		
(II) Advances outside India i) Due from banks ii) Due from others a) Bills purchased and discounted b) Syndicated loans c) Others		
Total		
Grand Total (C.I & C.II)		

Schedule 10 Fixed Assets		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
I. ***Premises*** At cost as on 31st March of the preceding year Additions during the year Deductions during the year Depreciation to date		

II. ***Other Fixed Assets*** (including furniture and fixtures) At cost as on 31st March of the preceding year Additions during the year Deductions during the year Depreciation to date		
Total (I & II)		

Schedule 11 **Other Assests**		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
I. Inter-office adjustments (net) II. Interest accrued III. Tax paid in advance/tax deducted at source IV. Stationery and stamps V. Non-banking assets acquired in satisfaction of claims VI. Others*		
Total		
* In case there is any unadjusted balance of loss the same may be shown under this item with appropriate footnote.		

Schedule 12 **Contingent Liabilities**		
	As on 31.3___ (current year)	*As on 31.3___ (previous year)*
I. Claims against the bank not acknowledged as debts II. Liability for partly paid Investments III. Liability on account of outstanding forward exchange contracts IV. Guarantees given on behalf of constituents (a) In India (b) Outside India V. Acceptances, endorsements and other obligations VI. Other items for which the bank is contingently liable		
Total		

Form 'B'
Form of Profit & Loss Account
For the year ended 31st March ______

		Year ended 31.3___ (current year)	*Year ended 31.3___ (previous year)*
I. ***Income*** Interest earned Other income Total			
II. ***Expenditure*** Interest expended Operating expenses Provisions and contingencies Total			
III. ***Profit / Loss*** Net Profit/loss ( ) for the year Profit/loss ( ) brought forward Total			
IV. ***Appropriations*** Transfer to statutory reserves Transfer to other reserves Transfer to – Government/Proposed dividend Balance-sheet			
Total			

Schedule 13
Interest Earned

	Year ended 31.3___ (current year)	*Year ended 31.3___ (previous year)*
I. Interest/discount on advances/bills II. Income on investments III. Interest on balances with Reserve Bank of India and other Inter-bank funds IV. Others		
Total		

Schedule 14 Other Income		
	Year ended 31.3___ (current year)	*Year ended 31.3___ (previous year)*
I. Commission, exchange and brokerage II. Profit on sale of investments *Less:* Loss on sale of investments III. Profit on revaluation of investments *Less:* Loss on revaluation of investments IV. Profit on sale of land, buildings and other assets *Less:* Loss on sale of land, buildings and other assets V. Profit on exchange transactions *Less:* Loss on exchange transactions VI. Income earned by way of dividends etc. from subsidiaries, Companies and/or joint ventures Abroad/in India VII. Miscellaneous income		
Total		

Note: Under items II to V, loss figures may be shown in brackets.

Schedule 15 Interest Expended		
	Year ended 31.3___ (current year)	*Year ended 31.3___ (previous year)*
I. Interest on deposits II. Interest on Reserve Bank of India/inter bank borrowings III. Others		
Total		

Schedule 16 Operating Expenses		
	Year ended 31.3___ (current year)	*Year ended 31.3___ (previous year)*
I. Payment to and provisions for employees II. Rent, taxes and lighting III. Printing and stationery IV. Advertisement and publicity V. Depreciation on bank's property VI. Directors' fees, allowances and expenses VII. Auditor's fees and expenses (including branch auditors' fees and expenses) VIII. Law Charges IX. Postage, telegrams, telephones, etc. X. Repairs and maintenance XI. Insurance XII. Other expenditure		
Total		

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PREVIOUS YEARS' QUESTION PAPERS

April 2016

[Time: Three Hours]
[Marks:100]

N.B:

1. Question **Nos I & II** are **compulsory** carrying **20 & 16 marks** respectively.
2. Attempt any **four** questions from the remaining carrying 16 marks each.
3. **Sub questions** would carry **equal marks** unless indicated to the contrary to their **extreme right.**
4. **Workings / References to Statute,** Standards, etc. (not necessary with reference no.s) to form part of your answer.
5. Make necessary assumptions wherever **required and state the same.**

I (a) The following is the account of MBT's capital A/c in the books of MBT & Co.

M/s MBT & Co's Ledger

Dr. MBT's Capital Account Cr.

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2015		Rs.	**2015**		Rs.
31st Jan.	To Cash A/c	1,60,000	1st Jan.	By Cash A/c	6,00,000
			1st Jan.	By Bank A/c	10,00,000
			1st Jan.	By Furniture A/c	4,00,000
			1st Jan.	By Land and Building	12,00,000
Feb 28th	To Cash A/c	2,00,000	July 1st	By Cash A/c	4,00,000
Dec 30th	To Purchases A/c	2,00,000			
Dec 31st	To Interest on Drawings	31,332	Dec 31st	By Interest on capital	1,20,000
			Dec 31st	By Profit & Loss A/c	2,40,000
Dec 31st	To Balance c/fd	33,68,668			
		39,60,000			**39,60,000**
			2016		
			1st **Jan**	By balance b/fd	33,68,668

You are required to analyse & interpret the above account.

(b) As an auditor of a company / entity state how would you deal with / respond to / comment on the following :

(1) Mr. Makrand is a proprietor carrying on a business of trading. During the year ended 31.03.2016, his turnover was Rs. 1,60,00,000. Mr. Makarand contemplates that the audit of financial statements is not mandatory for him. He appoints you as his consultant. Kindly advise.

(2) You are the auditor of Raheja Infrastructure Ltd. The company has recognised its income from dividend during the current financial year on accrual basis. The dividend was declared after the said financial year. Advise the company.

II (A) Match the items from Column A to those in Column B selecting on an overall most appropriate basis :

Column A	**Column B**
1. Internal Auditor	a) Does not apply to insurance companies
2. First Auditors	b) Compulsory for caustic soda Mfg. Co. & tyre & tube co's. (listed in respective schedule)
3. Reappointed of auditor	c) Examination of documentary evidence
4. CARO 2003	d) Turnover exceeding Rs.1 Crore
5. Cost Accounts	e) Reports to management
6. Vouching	f) By the management in Board Meeting
7. Tax Audit	g) By the shareholders in AGM
8. A.S. 10	h) Accounting for Fixed Assets
	i) No dividend
	j) Existence of ownership & possession

(B) Re-write the following sentences by choosing the most appropriate alternative :-

(i) ___________ is to be disclosed with financial statements as 'Accounting Policy followed'

a Treatment of Goodwill b Conservation

c Consistency d Cash

(ii) Accounting Standard 1 is __________.
a No Longer Valid b Optional
c Recommendatory d Mandatory

(iii) Arrears of fixed cumulative preference dividends are required to be shown under ________ in the balance sheet of the company.
a Fixed Assets b Share Capital
c Contingent liabilities d current liabilities

(iv) Goodwill & Patent Rights are ____________.
a Intangible Fixed Assets b Tangible Fixed Assets
c Fictitious Assets d None of the above.

(v) Bills for collection are shown in the Balance Sheet of a bank under _____________.
a Both Assets and Liabilities b Contingent Liability
c Liabilities Side d Assets only.

(vi) Opening Balances of Debtors ledger are checked from ___________.
a Audited accounts of earlier year
b Schedule of debtors of current year
c Schedule of Creditors of current year
d Trail balance of current year

(vii) Audit of bank is an example of __________
a Statutory Audit b Balance Sheet Audit
c None of the above d Both a & b

(viii) __________ appear under 'Provisions' in the Balance sheet.
a General Reserve b Capital reserve
c Sinking Fund d Proposed Dividend

III

(A) Explain the provision of :

(i) S.A. 500 in respect of Audit Evidence.

(ii) S.A. 220 in respect of quality control for an Audit of Financial Statements.

(B) Explain the provisions relating to :

(i) Audit of Banking company in respect of 'Rebate on Bill Discounted';

(ii) Audit of Insurance Company in respect of 'Premium Received & Premium Ceded'.

IV Write Short Notes on :

a) Audit of Educational Institutions.
b) Audit of Hospitals.
c) Share Transfer Audit.
d) Auditors' duty in respect of Forfeiture and Reissue of shares

V Explain the provisions of S.A.610 in relation to Auditors responsibilities regarding the work of Internal Auditors.

VI Explain important points in respect of :

a) Propriety Audit
b) Continuous Audit
c) Performance Audit
d) Auditors' duty in respect of Bonus Share.

VII Explain 10 points to be covered in the Companies (Auditor's Report) order 2003-
[CARO 2003]

VIII As an auditor of a company how would you audit the Rights issue of its shares?

IX Write short notes on any two of the following :—

(a) Audit of hotel.
(b) Audit of Club.
(c) Tax Audit
(d) Duties of Comptroller & Auditor General of India.
(e) Auditors responsibility relating to Fraud in an Audit of Financial Statement.

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May 2017

[Time: Three Hours]
[Marks:100]

Please check whether you have got the right question paper.

N.B:

1. Question Nos I & II are **compulsory** carrying **20 & 16 marks** respectively.
2. Attempt any **four** questions from the remaining carrying 16 marks each.
3. **Sub questions** would carry equal marks (duly approximated where required) unless indicated to the contrary to their extreme right.
4. **Workings / References to Statute,** Standards, etc. (not necessary with reference no.s) to form part of the solutions and necessary assumptions to be made and stated clearly.

(A) The following is the account of Dickybird & Co. in the books of M/s. Arihant Traders : **(12)**

Dr. **Cr.**

2016	PARTICULARS	Rs.	2016	PARTICULARS	Rs.
25/4	To Advance against order Ale	12,00,000	10/4	By Purchase a/c	12,00,000
20/5	To Advance against order Ale	22,50,000	05/5	By Purchase a/c	22,55,500
20/5	To Bank a/c	5,500	06/6	By Purchase a/c	25,10,000
16/6	To Bank a/c	24,49,800			
16/6	To Bank a/c	10,000			
16/6	To Discount Earned	50,200			
	Total	**59,65,500**		**Total**	**59,65,500**

Scrutinise and Interpret the aforesaid account.

(B) As an auditor, State in total details (including your reporting), how would you deal with respond to / comment on the following situations **(08)**

.

(i) A Government entity has spent 125.5 Crores on Urban Road development sector for the construction of new roads, w hich, though constitutes its activities and jurisdiction, the amount spent was from the funds sanctioned for Rural Irrigation activities.
(You are the Comptroller and Auditor General of India)

(ii) A Company has not provided nor otherwise notified in/along with the financial statements for depreciation working out to 25,00,000/- on its Fixed Assets of 2,50,00,000/- on the ground that these Assets were hardly put to use.

II (A) Match the items from Column A to those in Column B selecting on an overall most appropriate basis :

Column A	**Column B**
• S.A. 230	• Accounts of all Customers
• S.A. 500	• Audit compulsion under the Income-tax Act, 1961
• Purchase Ledger	• Audit documentation
• Audit of an Educational Institution	• Companies (Auditors' Report) Order not applicable
• S.A. 610	• Scope and powers much more than in Company Audit
Business with year's turnover exceeding □ 1 crore	• Objective and scope of Audit of Financial Statements
• Banking Company	• Trust Deed / Society Constitution
• Propriety Audit	• Audit Evidence
	• Accounts of Suppliers
	• Using the work of Internal Auditors

(B) Re-write the following sentences by choosing the most appropriate alternative :-

(i) The Annual General Meeting has to be conducted by __________ .

(Proprietory concern / Partnership / Company)

(ii) There exists a Standard on Audit on the __________ .

(external confirmations / initial audit engagement / both these)

(iii) __________ is an inherent aspect in Audit of Government entities.

(Propriety Audit / Companies Act audit / none of these)

(iv) In the case of __________ audit, the earlier year's accounts may not have been audited.

(Cooperative Society / Proprietory concern's / Government department)

(v) In Tax-Audit, form no. __________ containing various particulars will have to be attached to the Audit Report under section 44AB of the Income-tax Act.

(3CA / 3CB / 3CD)

(vi) In a Bank Audit, the Auditor will have to check compulsory transfer to the __________ .

(Statutory Reserve / Government / Capital Reserve)

(vii) In the audit of a __________ , its Register of Patients has to be verified.

(Hotel / Hospital / Government)

(viii) __________ has to follow Accrual basis of Accounting.

(Proprietory concern / Partnership / Company)

III (A) State the auditor's lookout necessary in Planning of Financial Audit as per S.A. 300.
(B) As an auditor, what overall 'Audit' objectives in its conduct would you pursue as per S.A. 200 ?

IV State the matters to be included under the Companies (Auditors' Report) Order, 2015 in respect of (i) Inter group loans and (ii) Statutory dues.

V Explain the various aspects as per the relevant S. A. in respect of Audit evidence to be followed by an Auditor.

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Report) Order, 2015.

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IX Write short notes on any two of the following :—
(a) Quality control for audit of Financial statements as per S.A. 220;
(b) The Auditors' concern with reference to Objective and scope of Audit of Financial statements;
(c) Salient features of the Audit of an Educational Institution;
(d) Important aspects in the Audit of a Banking company.

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December 2017

(3 Hours) **[Total Marks : 100]**

N.B. :

(1) Question Nos. **I** and **II** are **compulsory** carrying **20** and **16** marks **respectively**.

(2) Attempt any **four** questions from the **remaining**, carrying **16** marks **each**.

(3) **Sub-questions** would carry **equal** marks (duly approximated wherever required) unless indicated to the contrary to their extreme right.

(4) **Workings / References** to Statute, Standards, etc. (not necessaliry with reference no.s) to form part of the solutions and **necessary assumptions** to be made and stated clearly.

I (A) **15**

M/s. Heavy Machinery Mart
Machinery A/c

Date	**Particulars**	**F N**	Rs.	**Date**	**Particulars**	**F N**	Rs.
01-04-15	To Bank A/c		80,000	31-03-16	By Depreciation A/c (8000+10,000)		18,000
01-04-15	To X Machinery Mart A/c		1,00,000	31-03-16	By Bal c/d		1,62,000
	Total		**1,80,000**		**Total**		**1,80,000**
01-04-16	To bal B/d		1,62,000	31-03-17	By Cash		66,000
31-03-17	To P&L A/c		2,000	31-03-17	By Depreciation A/c (8000+10,000)		18,000
				31-03-17	By Bal c/d		80,000
	Total		**1,64,000**		**Total**		**1,64,000**

You are required to Analyse and Interpret the above Machinery A/c.

(B) As on Auditor, how would you proceed with verification of investments? **5**

II (A) Match the items from **Column A** to those in **Column B** selecting on an overall most appropriate basis : **8**

A	**B**
1 Internal Auditor	a. To be declared under CARO 2015
2 First Auditor's appointment	b. Turnover exceeding Rs. 1 Crore
3 Reappointment of Statutory Auditor	c. Accrual Basis of Accounting
4 Public Deposit	d. Compulsory for causic soda Mfg. Co. and tyre and tube Co. (listed in respective)
5 Tax Audit	
6 Company schedule	e. By the Management in Board Meeting
7 Caro 2015	f. Reports to Management
8 Cost Accounts	g. By the Shareholders in A.G.M.
	h. Does not apply to Insurance Co.

(B) Select the most appropriate option for the following sentences and **rewrite** the **entire statement** :— **8**

(i) __________ is basically responsible for prevention and detection of errors
and frauds.
(1) Auditor (2) Accountant
(3) Management (4) Cashier

(ii) Discount income on Bills is shown by the Bank __________ .
(1) In Schedule of interest earned
(2) In Schedule of Advances
(3) In Schedule of interest expended
(4) In Schedule of other income

(iii) Financial statements need to be prepared in accordance with __________ .
(1) Accounting standard issued by the Institute of Chartered Accountants of India.
(2) Relevant statutory requirement
(3) Relevant S. A.
(4) All of the above

(iv) Balance of Loan Account (Liability) is best verified by / from __________ .
(1) Ledger
(2) Cash Book
(3) Confirmation letter from Management
(4) Confirmation letter from the entity who has given the loan

(v) Current Assets do not include __________ .
(1) Inventories (2) Cash & Cash Equivalents
(3) Capital Work in progress (4) Trade Receivables

(vi) __________ is responsible for compliance with Accounting Standards.

(1) Director (2) Auditor
(3) Both these (4) None of these

(vii) Financial Statements have to be certified by __________ .

(1) Director (2) Auditor
(3) Both these (4) None of these

(viii) Interim dividend of a company can be declared by __________.

(1) Only the Shareholders
(2) Board of Directors after approval of stock exchange
(3) Board of Directors
(4) None of the above

III (A) Explain the provisions of :
(i) S. A. 230 in respect of Audit Documentation;
(ii) S. A. 500 in respect of Audit Evidence.

(B) Explain the provisions relating to :
(i) Cost Audit under Companies Act, 2013;
(ii) Proper Books of Accounts as per Companies Act, 2013.

IV Write short notes on any **two** of the following :—
(a) Audit of Hotels;
(b) Audit of Educational Institutions;
(c) Audit of Remuneration paid to the Directors.

V State the matters to be included under the Companies (Auditors' Report) Order, 2015 in respect of (a) Internal Control, (2) Loans given by the company.

VI Explain the Rights and Duties of Internal Auditor.

VII What are the special considerations that you would apply in the course of Audit of a Bank?

VIII Explain the important points in respect of Auditor's duty in relation to :
(a) Issue of Bonus Shares; (b) Issue of Right Shares;
(c) Sweat Equity Shares; (d) Propriety Audit.

IX Write short notes on any **two** of the following :—
(a) Duties of Comptroller and Auditor General of India;
(b) Tax Audit under section 44AB of the Income Tax Act 1961;
(c) Audit of a Hospital;
(d) Audit of Assets of Limited Company under the Companies Act, 2013.

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June 2018

[Time: Three Hours]
[Marks:100]

Please check whether you have got the right question paper.

N.B:
1. Question Nos I & II are **compulsory** carrying **20 & 16 marks** respectively.

2. Attempt any **four** questions from the remaining carrying 16 marks each.

3. **Sub questions** would carry equal marks (duly approximated where required) unless indicated to the contrary to their extreme right.

4. **Workings / References to Statute,** Standards, etc. (not necessary with reference no.s) to form part of the solutions and necessary assumptions to be made and stated clearly.

(A) The following is the account of Dickybird & Co. in the books of M/s. Arihant Traders : **(12)**

Dr. **Cr.**

2016	**PARTICULARS**	**₹**	**2016**	**PARTICULARS**	**₹**
25/4	To Advance against order Ale	12,00,000	10/4	By Purchase a/c	12,00,000
20/5	To Advance against order Ale	22,50,000	05/5	By Purchase a/c	22,55,500
20/5	To Bank a/c	5,500	06/6	By Purchase a/c	25,10,000
16/6	To Bank a/c	24,49,800			
16/6	To Bank a/c	10,000			
16/6	To Discount Earned	50,200			
	Total	**59,65,500**		**Total**	**59,65,500**

Scrutinise and Interpret the aforesaid account.

(B) As an auditor, State in total details (including your reporting), how would you deal with respond to / comment on the following situations. **(08)**

(i) A Government entity has spent 125.5 Crores on Urban Road development sector for the construction of new roads, w hich, though constitutes its activities and jurisdiction, the amount spent was from the funds sanctioned for Rural Irrigation activities.
(You are the Comptroller and Auditor General of India)

(ii) A Company has not provided nor otherwise notified in/along with the financial statements for depreciation working out to 25,00,000/- on its Fixed Assets of 2,50,00,000/- on the ground that these Assets were hardly put to use.

II (A) Match the items from Column A to those in Column B selecting on an overall most appropriate basis :

Column A	**Column B**
• S.A. 230	• Accounts of all Customers
• S.A. 500	• Audit compulsion under the Income-tax Act, 1961
• Purchase Ledger	• Audit documentation
• Audit of an Educational Institution	• Companies (Auditors' Report) Order not applicable
• S.A. 610	• Scope and powers much more than in Company Audit
• Business with year's turnover exceeding Rs. 1 crore	• Objective and scope of Audit of Financial Statements
• Banking Company	• Trust Deed / Society Constitution
• Propriety Audit	• Audit Evidence
	• Accounts of Suppliers
	• Using the work of Internal Auditors

(B) Re-write the following sentences by choosing the most appropriate alternative :-

(i) The Annual General Meeting has to be conducted by __________ .

(Proprietory concern / Partnership / Company)

(ii) There exists a Standard on Audit on the __________ .

(external confirmations / initial audit engagement / both these)

(iii) __________ is an inherent aspect in Audit of Government entities.

(Propriety Audit / Companies Act audit / none of these)

(iv) In the case of __________ audit, the earlier year's accounts may not have been audited.

(Cooperative Society / Proprietory concern's / Government department)

(v) In Tax-Audit, form no. __________ containing various particulars will have to be attached to the Audit Report under section 44AB of the Income-tax Act.

(3CA / 3CB / 3CD)

(vi) In a Bank Audit, the Auditor will have to check compulsory transfer to the __________ .

(Statutory Reserve / Government / Capital Reserve)

(vii) In the audit of a __________ , its Register of Patients has to be verified.

(Hotel / Hospital / Government)

(viii) __________ has to follow Accrual basis of Accounting.

(Proprietory concern / Partnership / Company)

III (A) State the auditor's lookout necessary in Planning of Financial Audit as per S.A. 300.

(B) As an auditor, what overall 'Audit' objectives in its conduct would you pursue as per S.A. 200 ?

IV State the matters to be included under the Companies (Auditors' Report) Order, 2015 in respect of (i) Inter group loans and (ii) Statutory dues.

V Explain the various aspects as per the relevant S. A. in respect of Audit evidence to be followed by an Auditor.

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