CHAPTER 1

QUALITY CONTROL



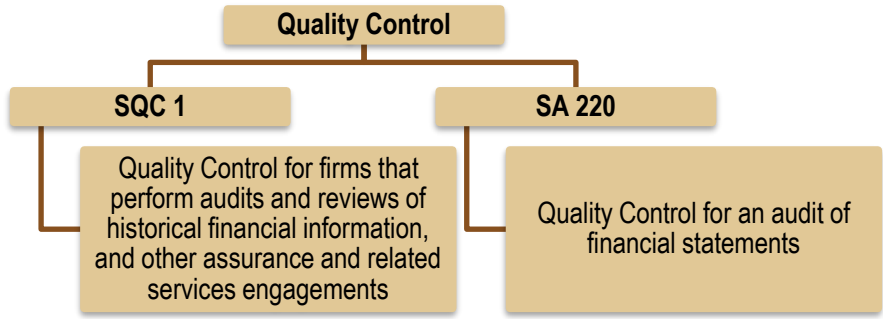
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Gain the knowledge about importance of audit quality.
- Understand the importance of quality control system in a firm.
- Clearly grasp import of SQC 1 and SA 220.
- Apply requirements of SQC 1 and SA 220 in practical situations.
- Understand importance of ethics in engagements.
- Differentiate between SQC 1 and SA 220.
- Understand relationship between SQC 1 and SA 220.
- Know briefly about mechanisms for review of audit quality.

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CHAPTER OVERVIEW



CA Jagriti is working in a firm of Chartered Accountants in capacity of a paid employee. The firm consists of 7 partners and is handling varied types of professional work including audits. There is heavy load of professional work on her and she handles few audit clients also. The firm's business is growing rapidly and many new clients have been added to the client base of the firm in past 2-3 years. In hindsight, she is thinking whether it was proper on part of the firm to accept new clients without checking and verifying their backgrounds.

Besides, she also feels that firm is accepting audits of some companies which are engaged in technical and complex operations. The firm has no past experience for audits of such clients. The partners also seemed to be stingy in hiring experienced and capable staff to handle such work. In her mind, she always lamented about the same. Are commercial considerations deciding and overriding factors? She was brooding.

Increase in volume of professional work without commensurate hiring of capable and qualified staff is leading to many lapses. She had handled audit of a listed company. The audit was completed, report issued, and annual report published. She found to her horror that audit report issued under the Companies Act, 2013 referred to "profit" in financial statements. However, audited financial statements reflected a "loss." She developed cold feet and cursed lack of a proper quality control system in the firm.

Similarly, in another case, she found that issued audit report of the company referred to "cash flow statement" whereas audited financial statements didn't comprise of a cash flow statement as it was a "small company" within meaning of the Companies Act, 2013.

She had made up her mind to make senior partner listen to her. Inviting attention to such serious lapses in reporting, she politely told her that firm was inviting troubles from regulators. She underlined need for a proper and effective quality control system in the firm to ensure that work was carried out in accordance with professional standards and applicable legal and regulatory framework so that audit report that is appropriate is issued.

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1. AUDIT QUALITY

High audit quality is central to the auditing profession. It helps in creating trust in users of financial information. Industry, government and public at large are the stakeholders who rely upon assurance given by auditors. It is, therefore, necessary to ensure high audit quality throughout the audit process. Audit quality involves the application of a rigorous audit process by auditors and quality control procedures that comply with laws, regulations and applicable professional standards.

SQC 1, "Quality Control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements" and SA 220, "Quality Control for an audit of financial statements" deals with issue of establishing quality control systems and responsibilities of auditors in this regard. Both the standards deal with framework of audit quality. SQC 1 applies to all engagements and deals with quality at the level of firm. SA 220 deals with audit quality at individual audit engagement level.

Besides the above two standards, other Standards on Auditing, Code of Ethics issued by ICAI and certain provisions of the Companies Act, 2013 facilitate quality control process. There also exists a mechanism for review of quality control through Peer Review Board, Quality Review Board and NFRA (National Financial Reporting Authority).

2. SQC 1 - QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS

SQC 1 requires that the firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm or engagement partners are appropriate in the circumstances. The firm's system of quality control should consist of policies designed to achieve these objectives. This quality control standard applies to all firms irrespective of their constitution.

2.1 Elements of System of Quality Control

The firm's system of quality control should include policies and procedures addressing each of the following elements: -

(a) Leadership responsibilities for quality within the firm

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(b) Ethical requirements

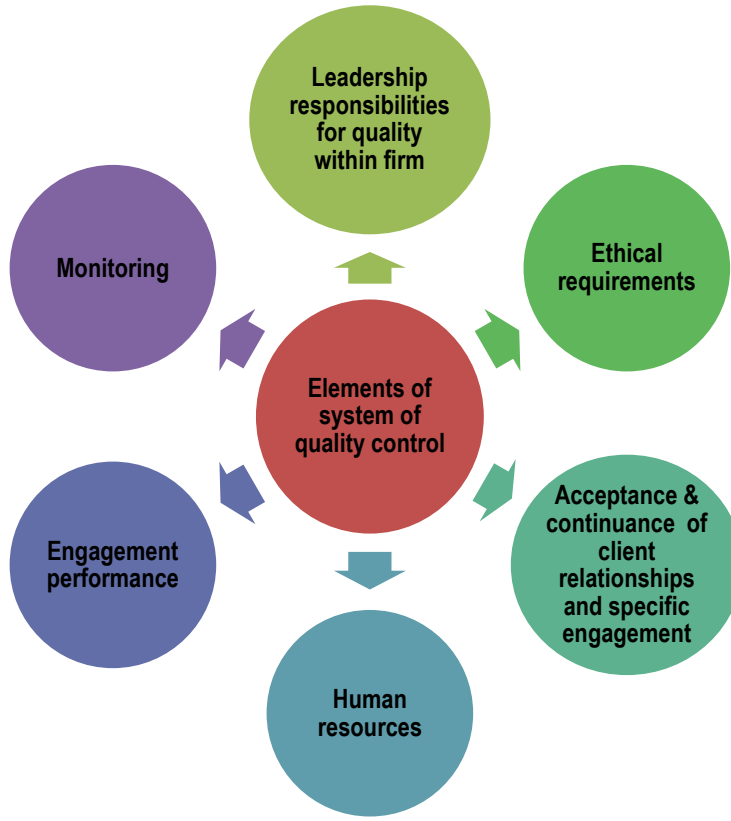
(c) Acceptance and continuance of client relationships and specific engagements

(d) Human resources

(e) Engagement performance

(f) Monitoring

Quality control policies and procedures should be documented and communicated to the firm's personnel. By communicating, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.



2.1.1 Leadership Responsibilities for Quality within the Firm

SQC 1 requires firms to establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to

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assume ultimate responsibility for the firm's system of quality control. The example set by firm's leadership encourages an inner culture that recognizes high quality audit work. Further, persons assigned operational responsibilities for the firm's quality control system by the firm's chief executive officer or managing partners should have sufficient and appropriate experience, ability, and the necessary authority to assume that responsibility.

It has been laid down clearly that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs. Essentially, it implies that audit quality is paramount in all engagements. It is non-negotiable. In this regard, it should be ensured that: -

(a) The firm assigns its management responsibilities so that commercial considerations do not override the quality of work performed.

(b) The firm's policies and procedures addressing performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel are designed to demonstrate the firm's overriding commitment to quality and

(c) The firm devotes sufficient resources for the development, documentation and support of its quality control policies and procedures.

TEST YOUR UNDERSTANDING 1

ABC & Associates, Chartered Accountants, has a policy to accept the clients wherein the risk evaluation is conducted with respect to the Company and the promoter. XYZ Limited approached ABC & Associates. The promoter of XYZ Limited is a close associate and family friend of Mr. A, Managing Partner of ABC & Associates. XYZ Limited has been in the news in the previous year for certain inquiries from the regulatory authorities in relation to certain matters. The existing auditor of XYZ Limited has resigned and has created a casual vacancy. XYZ Limited is ready to offer 25% more than the existing fees and has approached ABC & Associates for appointment as Auditor. Mr. A has a strong recommendation to the Firm to accept the audit.

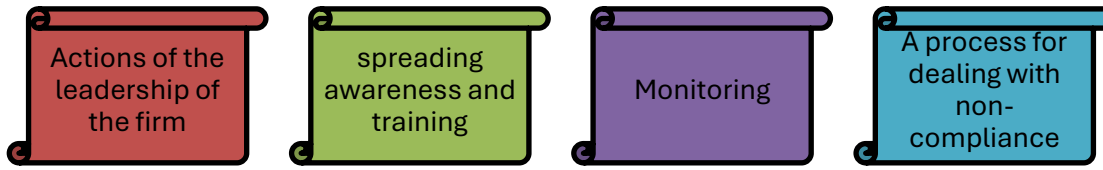
What is your understanding of the functioning of the tone at the top of the firm ABC & Associates, Chartered Accountants.? What are the considerations one should exercise to uphold Quality of the Firm?

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2.1.2. Ethical Requirements

The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements contained in the Code of Ethics issued by ICAI.

The Code establishes the fundamental principles of professional ethics which include integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. Fundamental principles should be emphasized by:



Observance of "Independence" in all engagements is the founding requirement. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and (including experts contracted by the firm and network firm personnel) maintain independence where required by the Code. Such policies and procedures should enable the firm to: -

(a) Communicate its independence requirements to its personnel
(b) Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.

There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence. All breaches of independence should be promptly notified to firm for appropriate action. Its objective is to ensure that independence requirements are satisfied.

At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

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SQC 1 lays special emphasis on *familiarity threat.* Using the same senior personnel on assurance engagements over a prolonged period may impair the quality of performance of the engagement. Therefore, the firm should establish criteria for determining the need for safeguards to address this threat. In determining appropriate criteria, the firm considers such matters as -

(a) the nature of the engagement, including the extent to which it involves a matter of public interest and

(b) the length of service of the senior personnel on the engagement.

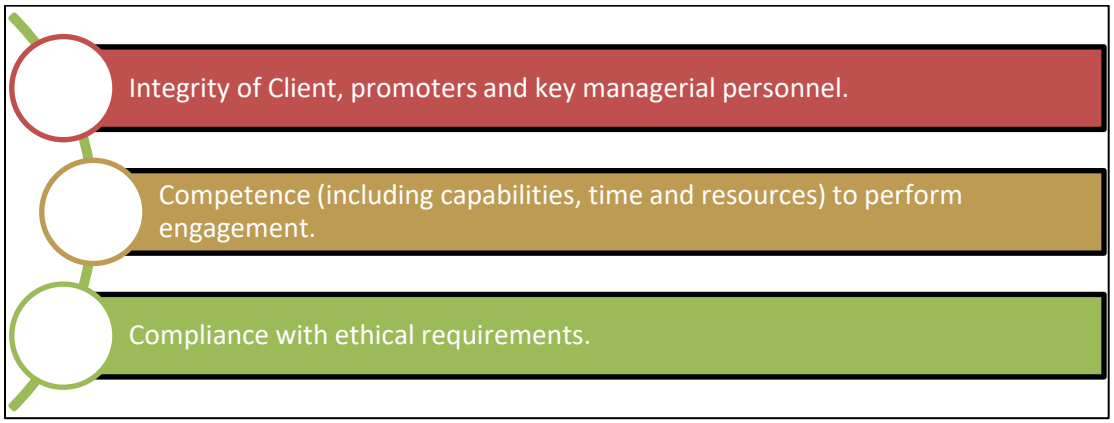
Examples of safeguards include rotating the senior personnel or requiring an engagement quality control review. The familiarity threat is particularly relevant in the context of financial statement audits of listed entities. For these audits, the engagement partner should be rotated after a pre-defined period, normally not more than seven years (except in cases where audit of listed entities is conducted by a sole practitioner). However, to ensure quality control exists in such firms and appropriate reports are issued, there is a process for mandatory peer review of such firms.

TEST YOUR UNDERSTANDING 2

MNP & Co., a firm of auditors, is appointed by a bank to conduct stock audit of a borrower. It deputes one of its paid Chartered accountant employees, Sudhanshu, to conduct above said stock audit. He leverages it as an opportunity to prevail upon the client to get the accounts audited from their firm. He also assures the client of a clean stock audit report without adverse comments as a *quid pro quo*. Is approach of Sudhanshu proper? How does it reflect upon the quality control system of firm?

2.1.3. Acceptance and Continuance of Client Relationships and Specific Engagements

A firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about: -



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The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm. The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

In considering whether the firm has the capabilities, competence, time and resources to undertake an engagement, following matters have to be taken into consideration: -

- Firm personnel have knowledge of relevant industries or subject matters;
- Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
- The firm has sufficient personnel with the necessary capabilities and competence;
- Experts are available, if needed;
- Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; and
- The firm would be able to complete the engagement within the reporting deadline.

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If there is any conflict of interest between the firm and client, it should be properly resolved before accepting the engagement. Where the firm obtains information that would have caused it to decline an engagement if that information had been obtainable earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:

(a) The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and

(b) The possibility of withdrawing from the engagement or from both the engagement and the client relationship.

Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

- Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.
- Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- Documenting significant issues, consultations, conclusions and the basis for the conclusions.

TEST YOUR UNDERSTANDING 3

CA M is introduced to a prospective client in a social function. He assures to visit office of CA M very soon in relation to professional work. During discussions over a cup of coffee next week, it transpires that there was a search by the Enforcement Directorate in his premises about a month back resulting in recovery of huge sum of cash. The income tax department had also searched his premises in relation to bogus capital gains on penny stocks. Complaining about the poor quality of services provided by his present auditor, he offers appointment as tax auditor of his five family-owned firms to CA M in lieu of handsome fees. What are the factors to be evaluated by CA M if he wants to take up the engagement?

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2.1.4. Human Resources

The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances. Such policies and procedures should address relevant HR issues including recruitment, compensation, training, career development, performance evaluation etc. There should be emphasis on the continuing professional development of the firm's personnel.

The firm should assign responsibility for each engagement to an engagement partner.

The firm should establish policies and procedures requiring that:
(a) The identity and role of the engagement partner are communicated to key members of the client's management and those charged with governance;
(b) The engagement partner has the appropriate capabilities, competence, authority and time to perform the role; and
(c) The responsibilities of the engagement partner are clearly defined and communicated to that partner.

Each engagement team should be able to carry out its responsibilities with necessary competence and skill. Therefore, the firm should ensure suitable people are available and groom them for their role. The firm should assess the performance of their partners and team members keeping in mind their commitment towards quality.

2.1.5. Engagement Performance

Consistency in quality of engagement performance is achieved through briefing of engagement teams of their objectives, processes for complying with engagement standards, processes of engagement supervision and training, methods of reviewing performance of work, appropriate documentation of work performed.

Consultation in difficult or contentious matters: Consultation should take place in difficult or contentious matters pertaining to an engagement.

Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter. It helps to promote quality and improves the application of professional judgment. Consultation procedures

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require consultation with those having appropriate knowledge, seniority and experience within the firm (or outside the firm) on significant technical, ethical and other matters and appropriate documentation and implementation of conclusions resulting from consultations.

A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by other firms or professional and regulatory bodies. Complete and proper documentation should be maintained on issues involved and results of consultation.

Engagement quality control review: Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer for taking an objective view before the report is issued.

The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

Engagement quality control review is mandatory for all audits of financial statements of listed entities. In respect of other engagements, firm should devise criteria to determine cases requiring performance of engagement quality control review.

An engagement quality control review for audits of financial statements of listed entities includes considering the following: -

- The engagement team's evaluation of the firm's independence in relation to the specific engagement.
- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
- Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
- The appropriateness of the report to be issued.

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Engagement quality control reviewer is a partner, other person in the firm (who should be member of ICAI), suitably qualified external person, or a team made up of such individuals. In this regard, suitably qualified external person refers to an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee (with appropriate experience) of another firm. In addition, the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities. It is necessary to maintain objectivity of such reviewer. Therefore, participation in engagement or making decisions for engagement team is to be avoided at all costs. However, engagement partner may consult engagement quality control reviewer during the engagement so as not to compromise his objectivity and eligibility to perform the role.

Where the nature and extent of the consultations become significant, however, care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person is appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement. The firm's policies should provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.

Differences of Opinion: *There* might be differences of opinion within engagement team, with those consulted and between engagement partner and engagement quality control reviewer. The report should only be issued after resolution of such differences. In case, recommendations of engagement quality control reviewer are not accepted by engagement partner and matter is not resolved to reviewer's satisfaction, the matter should be resolved by following established procedures of firm like by consulting with another practitioner or firm, or a professional or regulatory body.

Engagement documentation: The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. Engagement files should be completed in not more than 60 days after the date of auditor's report in case of audit engagements and in other cases within the limits appropriate to engagements.

Where two or more different reports are issued in respect of the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files should be considered for each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on a component's financial information for group consolidation purposes and, at a subsequent date, an auditor's report on the same financial information for statutory purposes.

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Policies and procedures should be designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.

Care should be taken that policies and procedures on documentation of the engagement quality control review should require documentation that: -

(a) The procedures required by the firm's policies on engagement quality control review have been performed.

(b) The engagement quality control review has been completed before the report is issued and

(c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

Engagement documentation has to be retained for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

In the specific case of audit engagements, the retention period ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

2.1.6. Monitoring

The firm should ensure that policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements. Quality control of engagements has to be monitored taking into account following factors:

- Deciding whether the quality control system of the firm has been appropriately designed and effectively implemented.
- Examining whether new developments in the professional standards, legal and regulatory requirements have been reflected in the quality control policies.
- Conducting monitoring by entrusting responsibility of monitoring process to a partner or other persons with sufficient and appropriate experience and authority in the firm.

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- Dealing with complaints and allegations against the firm or any employees of it of non-compliance with professional standards or appropriate regulatory requirements by a person within or outside the firm.
- Taking appropriate remedial actions against the personnel who did not conform to quality control policies.
- Taking action when deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control are identified.

3. SA 220 - QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS:

Based upon quality control system of firm, quality control policies pertaining to audit engagements are decided by engagement teams. The engagement partner of a team is responsible for quality control procedures of a particular audit engagement in accordance with SA 220.

Therefore, SA 220 is premised on the basis that the firm is subject to SQC 1. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise.

As per SA 220, the objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that: -	
(a)	The audit complies with professional standards and regulatory and legal requirements and
(b)	The auditor's report issued is appropriate in the circumstances.

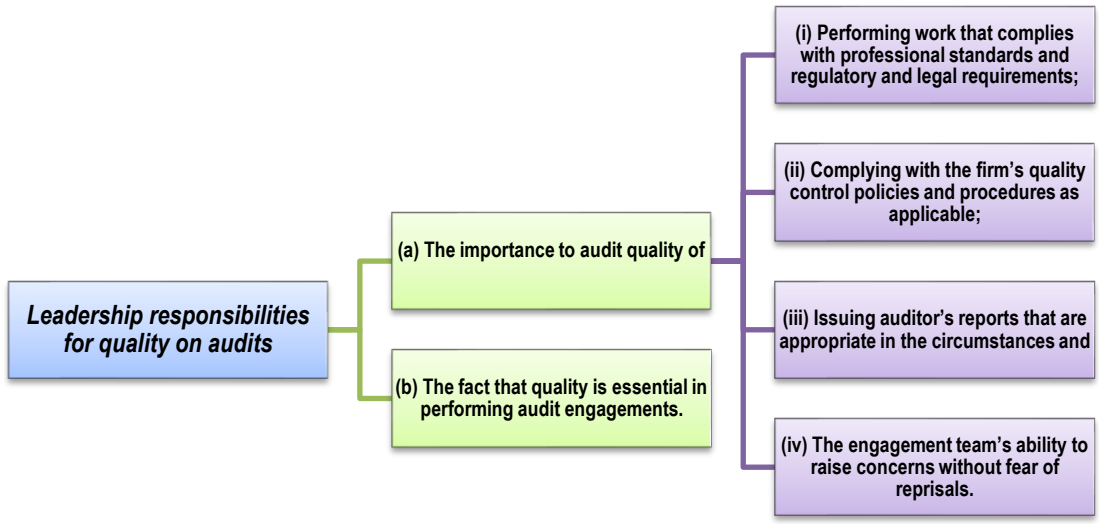
SA 220 is modelled on lines of SQC 1. It describes responsibilities of engagement partner in relation to following matters: -

(a) Leadership responsibilities for quality on audits.	**(b) Relevant ethical requirements.**
(c) Acceptance and continuance of client relationships and audit engagements.	**(d) Assignment of engagement teams.**
(e) Engagement performance.	**(f) Monitoring.**

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3.1 Leadership Responsibilities for Quality on Audits

Leadership responsibility of an engagement partner is to take responsibility for the overall quality on each audit engagement. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasis:



(a) The importance to audit quality of: -

(i) Performing work that complies with professional standards and regulatory and legal requirements;

(ii) Complying with the firm's quality control policies and procedures as applicable.

(iii) Issuing auditor's reports that are appropriate in the circumstances and

(iv) The engagement team's ability to raise concerns without fear of reprisals.

(b) The fact that quality is essential in performing audit engagements.

3.2 Relevant Ethical Requirements

The responsibilities of an engagement partner in relation to ethical requirements in an audit engagement are as under: -.

- Identifying a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level.

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- Reporting by engagement partner to the relevant persons within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

3.3 Acceptance and Continuance of Client Relationships and Audit Engagements

The responsibility of an engagement partner in this regard in an audit engagement is on lines of SQC 1 which requires the firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

Information like integrity of principal owners, competence of engagement team and consideration of necessary capabilities including time and resources, compliance with relevant ethical requirements and significant matters arisen during current or previous audit engagement and their implications assist the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate.

3.4 Assignment of Engagement Teams

It should be ensured by engagement partner that the engagement team and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the engagement in accordance with professional standards and regulatory and legal requirements.

3.5 Engagement Performance

Engagement partner has the responsibility for direction, supervision and performance of audit engagement in accordance with professional standards and regulatory and legal requirements. He is responsible for the auditor's report being appropriate in circumstances. Further, review of audit documentation before issue of audit report is his responsibility. It has to be ensured that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the issuance of the auditor's report.

The engagement partner is also responsible for ensuring undertaking appropriate consultation on difficult or contentious matters by engagement team not only within the team but also with others at appropriate level within or outside the firm.

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3.6 Engagement Quality Control Review

For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

(a) Determine that an engagement quality control reviewer has been appointed

(b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer

(c) Not date the auditor's report until the completion of the engagement quality control review.

The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:
(a) Discussion of significant matters with the engagement partner
(b) Review of the financial statements and the proposed auditor's report
(c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached and
(d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate

For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:

(a) The engagement team's evaluation of the firm's independence in relation to the audit engagement;

(b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations;

(c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached.

Differences of Opinion

If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

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TEST YOUR UNDERSTANDING 4

GVN & Associates are auditors of a listed company involved in "fin-tech" sector. The engagement team is stuck up with some issues pertaining to a particular Ind AS applicable to the company. They have framed a query and sent to ICAI for expert opinion on the matter. The issue was resolved upon receipt of expert opinion. Since expert opinion was provided by ICAI, engagement team was of the view that appointment of engagement quality control reviewer has lost its relevance. Do you agree?

3.7 Monitoring

An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

3.8 Documentation

The engagement partner should document following matters pertaining to an audit engagement: -

(a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.

(b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

(c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.

(d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.

Besides, the engagement quality control reviewer shall document, for the audit engagement reviewed, that:

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(a) The procedures required by the firm's policies on engagement quality control review have been performed.

(b) The engagement quality control review has been completed on or before the date of the auditor's report.

(c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

4. SQC 1 VS. SA 220- KEY DIFFERENCES IN NATURE, SCOPE AND APPLICABILITY

S.N.	*SQC 1*	*SA 220*
1	It applies to entire firm and fixes the responsibility of firm to be assumed by CEO or managing partners.	It applies to a particular audit engagement and engagement partner takes responsibility of the same.
2	It is applicable to audits, reviews of historical financial Information, and other assurance and related services engagements.	It is applicable to audit engagements only.
3	It relates to setting up of a quality control system consisting of policies and procedures for firm as a whole.	It deals with responsibilities of engagement teams to implement quality control procedures that are applicable to audit engagements.
4	It pertains to establishing a system of quality control designed to provide firm with a reasonable assurance that a firm and its personnel comply with professional standards and regulatory and legal requirements so that reports issued by firm or engagement partners are appropriate in circumstances.	It is premised on the basis that firm is subject to SQC 1. Therefore, SQC 1 is a *sine qua non* for applicability of SA 220. It is within overall context of a firm's system of quality control, engagement teams implement quality control procedures applicable to audit engagements.

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TEST YOUR UNDERSTANDING 5

RST & Co., a firm of Chartered accountants, are auditors of a listed company engaged in manufacturing of heavy machinery components. The audit report for the year 2023-24 also included reports on matters listed in CARO, 2020. While reporting under clause vii(a) of the said order relating to regularity of undisputed statutory dues by the company, the auditors have commented that company is "generally regular" in depositing statutory dues to appropriate authorities. Is the above reporting qualitative and in line with the requirements of SA 220?

5. MECHANISMS FOR REVIEW OF QUALITY CONTROL

5.1 Peer Review Board

Peer Review Board is constituted by Council of ICAI. The main objective of Peer Review Board is to ensure that, in carrying out assurance assignments: -

- Technical, professional and ethical standards including regulatory requirements are complied with by members of ICAI.
- Proper systems are in place including documentation thereof which amply demonstrates quality of assurance services provided by members.

Peer review is meant for the purpose of enhancing the quality of professional work resulting in more reliable and useful audit reports.

Peer review means an examination and review of the systems and procedures to determine whether the same have been put in place by the Practice Unit for ensuring the quality of assurance services as envisaged by the technical, professional and ethical Standards or any other regulatory requirements.

Once a Practice Unit is subjected to Peer review, its assurance engagement records pertaining to the Peer review period are subject to examination and review by the Peer Reviewer. On completion of this exercise, a "peer review certificate" is issued in case of unqualified report issued by Peer Reviewer. In case of a qualified report, it is informed to the Practice Unit that same cannot be issued along with the reasons therefor as well as inform about the due date for conducting a follow-on review as may be decided by the Board.

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5.2 Quality Review Board

Quality Review Board has been set up by Central government. It consists of members nominated by Central govt and Council of ICAI. The functions of QRB are: -

(a) To make recommendations to the Council regarding the quality of services provided by the members of the Institute;

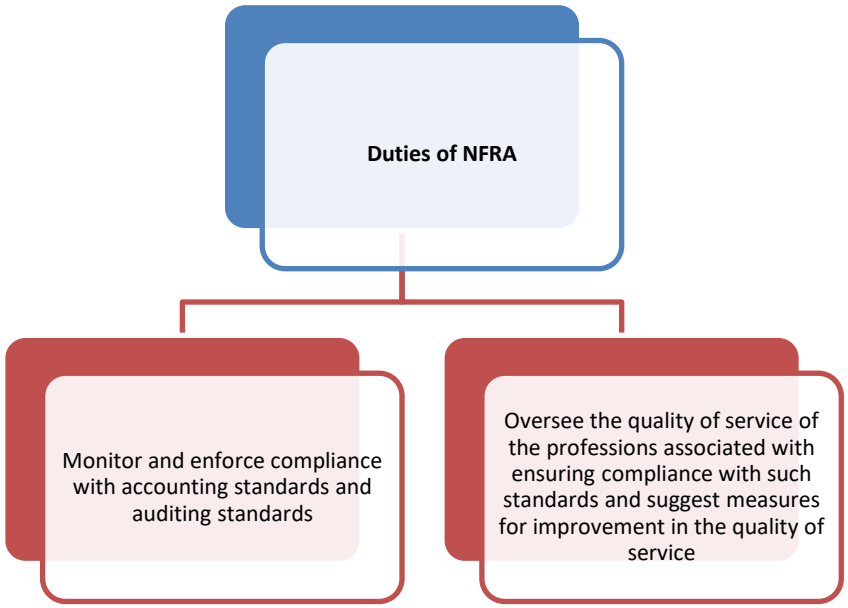
(b) To review the quality of services provided by the members of the Institute including audit services and

(c) To guide the members of the Institute to improve the quality of services and adherence to the various statutory and other regulatory requirements.

The statutory auditors in respect of the companies are identified for their audit quality review based upon risk-based approach. The review is carried out by technical reviewers who are empanelled by QRB on engagement basis from across the country.

5.3 National Financial Reporting Authority (NFRA)

NFRA has been constituted in terms of Section 132(1) of the Companies Act, 2013. Duties of NFRA also include the following: -



It has power to monitor and enforce compliance with accounting standards and auditing standards and oversee the quality of service under section 132(2) or undertake investigation under

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section 132(4) of the auditors of certain class of companies. Such companies include listed companies, insurance companies, banking companies and other companies as provided for in Rule 3 of the NFRA Rules, 2018.

Therefore, overseeing quality of audit services of listed companies falls under the purview of NFRA. QRB can review quality of audit services provided by the members of the Institute only in respect of entities other than those specified under Rule 3 of the NFRA Rules, 2018 and those referred to QRB by NFRA under relevant rules.

Key Takeaways

- SQC 1 requires that the firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm or engagement partners are appropriate in the circumstances.
- SQC 1 is applicable to audits, reviews of historical financial Information, and other assurance and related services engagements. It is applicable to all firms irrespective of their constitution.
- Elements of system of quality control envisaged in SQC 1 include establishing leadership responsibilities for quality within the firm, complying with ethical requirements, acceptance and continuance of client relationships and specific engagements, establishing policies and procedures addressing issues of capabilities, competence, and commitment of human resources in firm to carry out engagements, engagement performance and monitoring.
- In respect of difficult or contentious matters, consultation may be required at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter.
- Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer for taking an objective view before the report is issued. The review does not reduce the responsibilities of the engagement partner.
- Engagement quality control review is mandatory in respect of listed entities.
- The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. Engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements and in other cases within the limits appropriate to engagements.

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- Engagement documentation has to be retained for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.
- In the specific case of audit engagements, the retention period ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.
- SA 220 is applicable to audit engagements only. It deals with responsibilities of engagement teams to implement quality control procedures that are applicable to audit engagements.
- SA 220 is premised on the basis that firm is subject to SQC 1. It is within the overall context of a firm's system of quality control, engagement teams implement quality control procedures applicable to audit engagements.
- Besides SQC 1 and SA 220, other Standards on Auditing, Code of Ethics issued by ICAI and certain provisions in the Companies Act, 2013 facilitate quality control process. There also exists mechanism for review of quality control through Peer Review Board, Quality Review Board and NFRA (National Financial Reporting Authority).

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM: SCAN ME !



TEST YOUR KNOWLEDGE

Theoretical Questions

1. *PQR & Associates are statutory auditors of a listed company. There arose an issue during the course of audit relating to related party transactions. The engagement partner wants to consult an engagement quality control reviewer on this matter during the course of audit process itself. Can he consult with engagement quality control reviewer? Discuss.*

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2. *Beta Private Limited has approached a firm of Chartered accountants to assist them in preparation of financial statements and issue a compilation report in this regard. Does CA firm have responsibility in relation to quality control for above said engagement? Discuss with reasons.*

3. *Ramanujan, a CA final student, feels that engagement file in audit engagement should be ready prior to issue of audit report. Discuss whether Ramanujan's view is in order.*

4. *BNE & Co. are in midst of audit process of a listed company. During the audit, an issue arose relating to revenues from contracts with customers in terms of Ind AS 115. The engagement partner took a certain stand. However, engagement quality control reviewer recommended otherwise after review. The engagement partner is not willing to accept recommendations of reviewer. How can this conflict be resolved?*

5. *MB & Associates is a partnership firm of Chartered Accountants which was established seven years back. The firm is getting new clients and has also been offered new engagement services with existing clients. The firm is concerned about obtaining such information as it considers necessary in the circumstances before accepting an engagement with a new client and acceptance of a new engagement with an existing client. The firm is looking to work with only select clients to adhere to the Quality Control Standards. Guide MB & Associates about the matters to be considered with regard to the integrity of a client, as per the requirements of SQC 1.*

6. ***SPS & Associates, Chartered Accountants, are statutory auditors of Grec Limited for the last two years. Grec Limited is engaged in the manufacturing and marketing of pharmaceutical goods in India. During the year 2023-24, the company has diversified and commenced providing software solutions in "e-commerce" in India as well as in certain African countries. SPS & Associates, while carrying out the audit, noticed that the company has expanded its operations into a new segment as well as in a new country. SPS & Associates does not possess the necessary expertise and infrastructure to carry out the audit of these diversified business activities and accordingly wishes to withdraw from the engagement and client relationship. Discuss the issues that need to be addressed before deciding to withdraw.***

7. ***PQR Associates are the statutory auditors of a large un-listed company, which is engaged in manufacturing of auto components. Subsequent to reappointment of auditors in the Annual General Meeting, the Company shared the appointment letter with PQR Associates, seeking acknowledgement and acceptance letter. CA R is the***

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engagement partner and is planning to issue the acceptance letter. During the current financial year, there was a search by the Income-tax Authorities on the company, and certain accounting records were seized for verification. Based on the information available on social media, CA R noted that the promoters' brother is contemplating to contest in the ensuing elections, under the banner of a political party. One of the current senior engagement team manager, who has been doing the audit engagement till last year, has left PQR Associates and is planning to provide some accounting services to one of the associate companies. PQR Associates are yet to recruit another senior manager having adequate experience in the audits of clients engaged in the automotive sector. Elaborate the matters to be considered by PQR Associates with respect to acceptance & continuance of client relationships considering the above issues.

8. *CA Giri is a senior partner of M/s TSV Associates. M/s TSV Associates is a reputed firm of Chartered Accountants which has been in practice for more than five decades. The firm undertakes statutory audits of large listed companies across various industry sectors and has more than fifty qualified experienced professionals. CA Giri has been assigned as an Engagement Quality Control Reviewer for an audit engagement of a listed company. What are the aspects which would be looked into by CA Giri as an EQCR in relation to the engagement?*

   Upon completion of the review, CA Giri has identified certain issues with respect to revenue recognition and adequacy of provisions relating to onerous contracts. The views of CA Giri are not accepted by the Engagement Partner. Suggest ways of resolving the differences of opinion between CA Giri and the engagement partner.

9. *TPX & Co., Chartered Accountants, is a large audit firm. It maintains audit documentation both electronically and in physical form (hard files). The physical files are neither scanned and incorporated into electronic files nor cross-referenced to the electronic files. Further, there are many instances where audit working papers do not contain details as to whether information was obtained from client or prepared by engagement team. How do you view the above situation from the point of view of quality control system in audit firm? Analyse.*

10. *Pine & Associates is the statutory auditor of BB Ltd., a listed company and started its operations 6 years ago. The fieldwork during the audit of the financial statements of the company for the year ended 31st March, 2024 was completed on 1st May, 2024. The auditor's report was dated 15th May, 2024. During the documentation review of the*

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engagement, it was observed that the engagement quality control review was completed on 18th May, 2024. The engagement partner had completed his reviews in entirety by 12th May, 2024. Comment.

Answers to Test your Understanding

1. The given situation indicates that proposed client is a new one whose promoter is close associate and family friend of managing partner of M/s ABC & Associates. However, the previous auditor of proposed client has resigned and company is offering hike in audit fees in comparison to audit fees paid to previous auditor. Besides, there are also regulatory inquires against the company. In spite of all this, managing partner of firm Mr. A has recommended for acceptance of offered audit of the company.

It reflects poorly regarding functioning at the top of the firm as regards quality control. SQC 1 requires that the firm establish a system of quality control designed to provide it with reasonable assurance that firm and its personnel comply with professional standards and legal and regulatory requirements. It further requires that the firm's business strategy is subject to overriding the requirement of firm to achieve quality in all engagements. However, in the given situation, commercial considerations seem to be an overriding factor.

The managing partner of firm is close associate and family friend of promoter. The matter should have been brought to knowledge of firm in accordance with requirements of SQC 1 as it involves issue of independence of managing partner of the firm with respect to proposed audit engagement. Further, matters of inquiries from regulators and resignation of previous auditor raise question about integrity of the proposed client. SQC 1 further requires firm to consider before acceptance of an engagement that client does not lack integrity. All these factors need to be taken into consideration before accepting engagement.

Overall, such a situation reflects lack of proper establishment of quality control framework at top of the firm. Following considerations should be taken into account while upholding quality of firm: -

(i) The firm assigns its management responsibilities so that commercial considerations do not override quality of work performed

(ii) The firm's policies and procedures in relation to its personnel are designed to demonstrate its overriding commitment to quality.

(iii) The firm devotes sufficient resources for development and documentation of its quality control policies and procedures

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(iv) A firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about integrity of Client, promoters and key managerial personnel, competence (including capabilities, time and resources) to perform engagement and compliance with ethical requirements.

2. Approach of Sudhanshu is not proper. Such practices clearly violate Code of Ethics and its spirit. It reflects poorly upon the quality control system of firm envisaged in SQC 1 which requires that quality control policies and procedures should be documented and communicated to the firm's personnel. It shows that firm's personnel are not properly sensitized regarding requirements of SQC 1.

3. As per SQC 1, before accepting a new engagement, integrity of client should be considered including matters that indicate involvement in money laundering or criminal activities. There has been search of ED on the said party leading to recovery of huge amount of cash. The above coupled with actions of income tax department relating to bogus capital gains on penny stocks indicates that client might be involved in money laundering activities. Therefore, offer should not be accepted.

4. Engagement quality control review in listed entities is a mandatory requirement. Expert opinion of ICAI pertains to the issue of interpretation. The appointment of reviewer is a separate and mandatory requirement in audits of listed companies.

5. Such type of reporting is not qualitative. It is not in accordance with SA 220. One of the objectives of the auditor, as per SA 220, is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that the audit complies with professional standards and regulatory and legal requirements. The reporting under CARO, 2020 is not proper. Hence, the audit does not comply with regulatory and legal requirements.

Hints /Answers to Theoretical Questions

1. It is necessary to maintain objectivity of reviewer. Therefore, participation in engagement or making decisions for engagement team is to be avoided at all costs. However, engagement partner may consult engagement quality control reviewer during the engagement so as not to compromise his objectivity and eligibility to perform the role.

2. Such kind of services fall in category of "related services". SQC 1 is applicable to all type of engagements including engagement pertaining to "related services".

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3. The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. Engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements. Thus, view of Ramanujan is not in order.

4. In case, recommendations of engagement quality control reviewer are not accepted by engagement partner and matter is not resolved to reviewer's satisfaction, the matter should be resolved by following established procedures of firm like by consulting with another practitioner or firm, or a professional or regulatory body. The audit report should be issued only after resolution of the matter.

5. As per SQC 1, the firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

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6. *As per SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", the firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will undertake or continue relationships and engagements only where it is competent to perform the engagement and has the capabilities, time and resources to do so.*

   In the given case, SPS & Associates, Chartered Accountants, statutory auditors of Grec Limited for the last two years, came to know that the company has expanded its operations into a new segment as well as in new country. SPS & Associates does not possess the necessary expertise for the same, therefore, SPS & Associates wish to withdraw from the engagement and client relationship. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

   Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.

   If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.

   Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.

   Documenting significant issues, consultations, conclusions, and the basis for the conclusions.

   SPS & Associates should address the above issues before deciding to withdraw.

7. *Acceptance and Continuance of Client Relationships: As per SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements," a firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about: -*

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- *Integrity of Client, promoters, and key managerial personnel.*
- *Competence (including capabilities, time, and resources) to perform engagement.*
- *Compliance with ethical requirements.*

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

Further, as per SA 220, "Quality Control for an Audit of Financial Statements", the engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence.

In view of the above, PQR Associates should:

- ✓ *follow their firm's policies and procedures for client acceptance and continuance. This includes evaluating the integrity of the client, assessing potential risks associated with the engagement, and ensuring the firm has the necessary resources and expertise to perform the engagement effectively. The engagement team, should assess, whether the company is involved in any funding activities, to the political parties, and if so enquire and assess the risks related to such transactions.*
- ✓ *communicate clearly with the client regarding the scope of the engagement, the responsibilities of both parties, and any limitations on the services to be provided. This helps manage expectations and ensures alignment between the firm and the client.*
- ✓ *independence and objectivity throughout the engagement. Any potential threats to independence, such as relationships with the client's affiliates or involvement in political activities by related parties, should be evaluated and mitigated appropriately. Since the senior manager who was on this engagement is providing certain accounting services, to one of the group companies, the engagement partner, should assess, whether it would have any impact on the audit and examine the relevant ethical/independence requirements.*

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- ✓ *continually monitor the client relationship for any changes or developments that may impact the firm's ability to provide services effectively. This includes staying informed about significant events such as the income-tax search, changes in client management, or potential conflicts of interest. Since there was an income-tax raid on the organisation, the engagement partner should evaluate the risks of material misstatements, and non-disclosure of tax disputes and liabilities.*
- ✓ *ensure that their engagement team possesses the necessary competence and capabilities to perform the audit effectively. The departure of a senior manager and the need to recruit a replacement with specific industry experience should be addressed promptly to maintain audit quality. Since one of the senior engagement team members has left PQR Associates, the engagement partner should assess, whether he would be in a position to devote adequate time on the engagement or whether to recruit another resource, before commencement of the audit.*

8. *As per SA 220, "Quality Control for an Audit of Financial Statements", for audits of financial statements of listed entities, CA Giri, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:*

   (i) The engagement team's evaluation of the firm's independence in relation to the audit engagement;

   (ii) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations;

   (iii) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached.

   As per SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements,", there might be difference of opinion within engagement team, with those consulted and between engagement partner and engagement quality control reviewer. The report should only be issued after resolution of such differences. In case, recommendations of engagement quality control reviewer are not accepted by engagement partner and matter is not resolved to reviewer's satisfaction, the matter should be resolved by following established procedures of firm like by consulting with another practitioner or firm, or a professional or regulatory body.

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In the given situation, under completion of review, CA Giri, Engagement Quality Control Reviewer has identified certain issues. However, the view of CA Giri, the EQCR are not accepted by the Engagement Partner. This difference of opinion among the CA Giri and Engagement Partner should be resolved with abovementioned manner as per SQC 1.

9. *In accordance with SQC 1," Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements" the firm should establish policies and procedures designed to maintain confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.*

In the given situation, the physical files are neither scanned and incorporated in the electronic files nor cross-referenced to the electronic files. Inability to do so shows that firm has not established policies and procedures to maintain integrity of engagement documentation. Lack of ensuring the same makes it difficult to demonstrate completeness of audit files and whether these were assembled within 60 days timeframe stipulated in SQC 1.

Where engagement documentation is in paper, electronic, or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. One of the reasons for designing and implementing appropriate controls for engagement documentation in this regard is the protection of the integrity of information at all stages of engagement.

For the practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In that case, the firm implements appropriate procedures requiring engagement teams to:

(a) Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;

(b) Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and

(c) Enable the scanned copies to be retrieved and printed as necessary.

It has also been stated that there are many instances where audit working papers do not contain details as to whether information was obtained from the client or prepared by the engagement team. It is important to identify the source of the document and the

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information used as audit evidence to ensure its reliability. It could have potential risks of non-compliance with Standards on Auditing.

10. *As per SA 220, "Quality Control for an Audit of Financial Statement", the engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.*

For audits of financial statements of listed entities, the engagement partner shall:

- *Determine that an engagement quality control reviewer has been appointed;*
- *Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and*
- *Not date the auditor's report until the completion of the engagement quality control review.*

Further, SA 700," Forming an Opinion and Reporting on Financial Statements", requires the auditor's report to be dated not earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements. In cases of an audit of financial statements of listed entities where the engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

In this case, the audit of BB Ltd. for the year ending on 31st March 2024 was conducted by Pine & Associates and was completed on 1st May, 2024. Subsequently, the engagement partner reviewed the audit by 12th May, 2024. The audit report issued by Pine and Associates was dated 15th May, 2024. However, the engagement quality control review was finalized on 18th May, 2024, which is later than the date of the audit report. In view of above, the date of auditors' report before the completion of the engagement quality control review, is not correct.

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CHAPTER 2

GENERAL AUDITING PRINCIPLES AND AUDITORS RESPONSIBILITIES



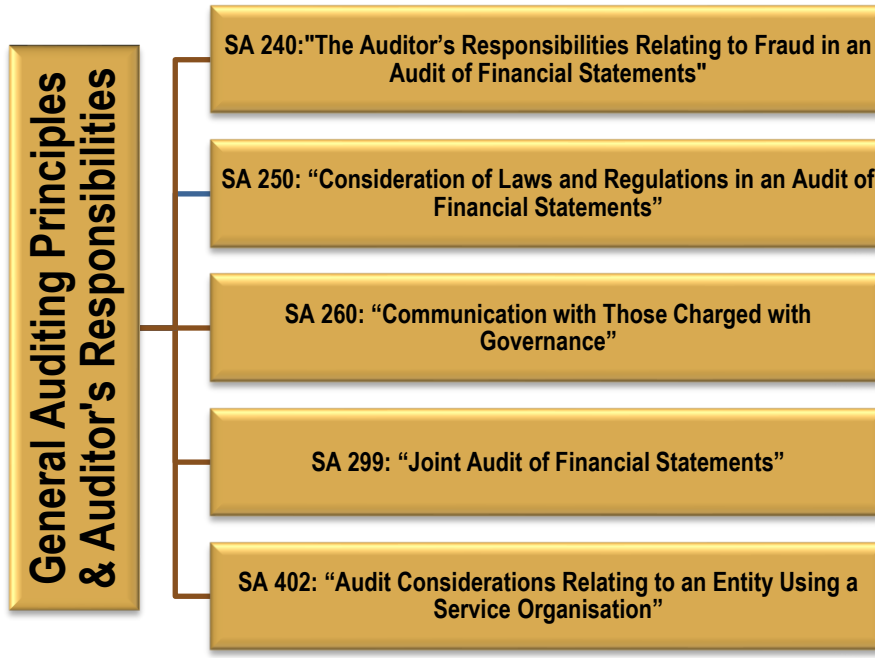
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand meaning of fraud and its characteristics, fraud risk factors with examples etc.
- Gain knowledge about SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".
- Gain knowledge about SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements".
- Learn about significance of communication with those charged with governance and gain knowledge about SA 260 "Communication with Those Charged with Governance".
- Gain knowledge about SA 299 "Joint Audit of Financial Statements".
- Gain knowledge about SA 402 "Audit Considerations Relating to an Entity Using a Service Organisation".

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CHAPTER OVERVIEW



CA. Bijoy is auditor of a listed company since last three years. Of late, the company is in news in financial circles for all the wrong reasons. There have been allegations of flouting of Securities Contracts (Regulation) Rules by clandestinely controlling more than required percentage of shares than mandated in rules. Besides, the said company has been accused of violating other provisions of securities laws.

There have also been allegations of manipulating share prices, of artificially keeping share prices high and failure to disclose all related party transactions. The company is a highly leveraged one. However, there has been no default and company has kept its commitments. SEBI is also seized of the matter on its own.

Ever since the above allegations were hurled through media, auditor of the company is in a fix. What do such allegations reflect? How he should proceed in audit of ensuing year? The regulatory report would take time and audit has to be completed within timelines. Audits of last two years were conducted in accordance with Standards on Auditing and no wrongdoings were noticed and unmodified opinion was expressed in audit reports. However, given the current scenario, there seemed to be a heightened level of audit risk. It would be foolish of him not to take notice of such developments.

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The allegations of violations of securities laws, manipulating share prices and failure to disclose all related party transactions could be fraud risk factors. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred. Hence, there are increased risks of material misstatement due to fraud. Due to assessment of increased risks of material misstatement due to fraud, audit procedures need to be designed and performed accordingly.

Besides above, suspected non-compliance with laws and regulations may have material effect on financial statements. It could involve hefty penalties and other issues. If management is not forthcoming in providing information relating to compliance with laws and regulations, does he need to obtain legal advice? Whether it would also lead to any impact on his opinion? Such questions were staring him in the face in current year of his tenure.

If he suspects fraud involving management, should he communicate these suspicions to audit committee and discuss with them nature, timing, and extent of audit procedures necessary to complete the audit?

1. GENERAL AUDITING PRINCIPLES AND AUDITOR'S RESPONSIBILITIES

SA 200 establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Audit has to be planned and performed with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Misstatements can arise from errors or frauds. SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. The auditor has to remain alert throughout the audit recognizing the possibility that material misstatement due to fraud could exist.

Entities are subject to various laws and regulations. Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity leading to material effect on financial statements. SA 250 deals with auditor's responsibilities in this regard while performing an audit of financial statements. Since many laws and regulations affect entities, auditor has to remain alert to the possibility of non-compliance with laws and regulations.

Communication with those charged with governance on a timely basis during audit serves many useful purposes and SA 260 deals with auditor's responsibilities in this regard. SA 299 details special consideration relating to responsibilities of auditors in a joint audit.

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It is very common for user entities these days to outsource activities from a third-party service organization. SA 402 dwells upon the user auditor's responsibility to obtain sufficient appropriate audit evidence in this respect.

2. SA 240 "THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS"

SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Its requirements assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

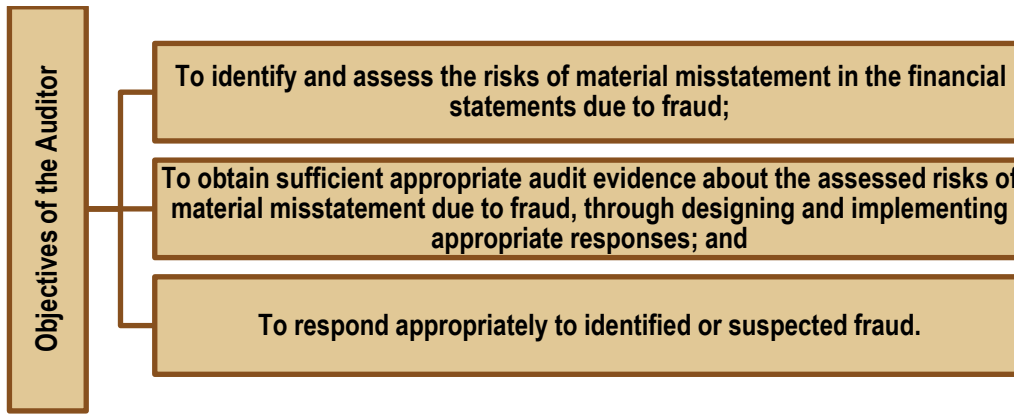
2.1 Objectives of the Auditor in accordance with SA 240

The objectives of the auditor in accordance with SA 240 are: -

(a) To identify and assess the risks of material misstatement in the financial statements due to fraud;

(b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

(c) To respond appropriately to identified or suspected fraud.



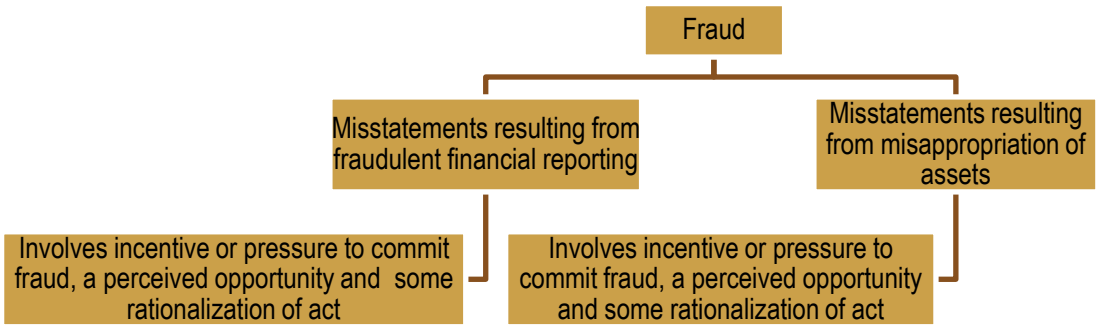
Meaning of Fraud and its Characteristics

Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

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Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Although fraud is a broad legal concept, the auditor is concerned with fraud that causes a material misstatement in the financial statements.



Two types of intentional misstatements are relevant to the auditor: -
• **Misstatements resulting from fraudulent financial reporting**
• **Misstatements resulting from misappropriation of assets**

Fraud, whether due to misstatements resulting from fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. **For example: -**

Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant.	**Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.**	**A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.**	**Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.**

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2.2 How Fraudulent Financial Reporting may be caused by Entities?

Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

Fraudulent financial reporting may be accomplished by the following: -

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as: -
➢ **Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.**
➢ **Inappropriately adjusting assumptions and changing judgments used to estimate account balances.**
➢ **Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.**
➢ **Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.**
➢ **Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.**
➢ **Altering records and terms related to significant and unusual transactions.**

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2.3 How Misappropriation of Assets may be accomplished by Entities?

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

Misappropriation of assets can be accomplished in a variety of ways including: -

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

2.4 Whose Primary Responsibility is to Prevent and Detect Fraud?

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on *fraud prevention*, which may reduce opportunities for fraud to take place, and *fraud deterrence*, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an active oversight by those charged with governance.

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2.5 Responsibilities of the Auditor

An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

The potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false.

The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

What are fraud risk factors?

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. For example: -

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;

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- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

Examples of fraud risk factors: Following are examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting and from misappropriation of assets respectively : -

[A] Risk factors relating to misstatements arising from fraudulent financial reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting: -

Incentives/Pressures
Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by): -
➢ **High degree of competition or market saturation, accompanied by declining margins.**
➢ **High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.**
➢ **Significant declines in customer demand and increasing business failures in either the industry or overall economy.**
➢ **Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.**
➢ **Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.**
➢ **Rapid growth or unusual profitability especially compared to that of other companies in the same industry.**
➢ **New accounting, statutory, or regulatory requirements.**

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following: -

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive— including financing of major research and development or capital expenditures.

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- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following: -

- **Significant financial interests in the entity.**
- **Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.**
- **Personal guarantees of debts of the entity.**
- **There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.**

Opportunities: The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following: -

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

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The monitoring of management is not effective as a result of the following: -

Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.	Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organizational structure, as evidenced by following: -

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following: -

- **Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).**
- **High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.**
- **Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.**

Attitudes/Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.

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- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following: -

  • Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.

  • Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.

  • Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.

  • Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

[B] Risk factors relating to misstatements arising from misappropriation of assets

The following are examples of risk factors relating to misstatements arising from misappropriation of assets: -

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following: -

- **Known or anticipated future employee layoffs.**

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- **Recent or anticipated changes to employee compensation or benefit plans.**
- **Promotions, compensation, or other rewards inconsistent with expectations.**

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following: -

- Large amounts of cash on hand.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- **Inadequate segregation of duties or independent checks.**
- **Inadequate oversight of senior management expenditures, such as travel and other reimbursements.**
- **Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.**
- **Inadequate job applicant screening of employees with access to assets.**
- **Inadequate record keeping with respect to assets.**
- **Inadequate system of authorization and approval of transactions (for example, in purchasing).**
- **Inadequate physical safeguards over cash, investments, inventory, or fixed assets.**
- **Lack of complete and timely reconciliations of assets.**
- **Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.**
- **Lack of mandatory vacations for employees performing key control functions.**
- **Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.**
- **Inadequate access controls over automated records, including controls over and review of computer systems event logs.**

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Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behaviour indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behaviour or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

Why evaluation of fraud risk factors by auditor is necessary?

The auditor shall evaluate whether one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud.

The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify fraud risk factors. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

2.6 Maintaining Professional Skepticism

The auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.

Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

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2.7 Discussion among the Engagement Team

The discussion among the engagement team shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity.

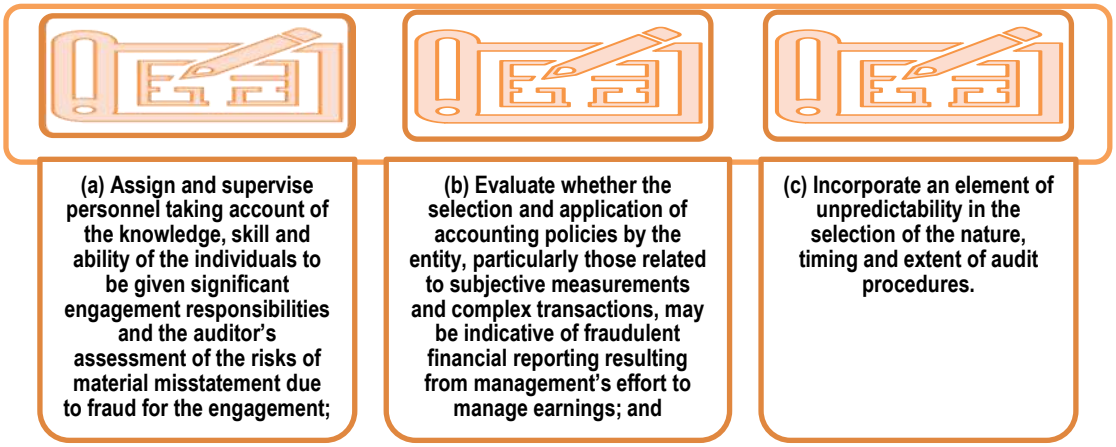
2.8 Risk Assessment Procedures and Related Activities be geared towards Obtaining Information for use in Identifying Risk of Material Misstatement due to Fraud

When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, the auditor shall perform the procedures to obtain information for use in identifying the risks of material misstatement due to fraud like inquiries of management and others within the entity, obtaining understanding as to how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks and evaluation of unexpected relationships identified in performing analytical procedures which may indicate risks of material misstatement due to fraud.

Besides, as discussed already, the auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present.

2.9 Responses to the Assessed Risks of Material Misstatement due to Fraud at the Financial Statement Level

In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall: -



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2.10 Audit Procedures Responsive to Assessed Risks of Material Misstatement due to Fraud at the Assertion Level

The auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level. In doing so, the auditor may change nature, timing and extent of audit procedures to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information.

For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

2.11 Audit Procedures Responsive to Risks related to Management Override of Controls

Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. This risk is present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to: -

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

(b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud.

(c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

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The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above.

2.12 Evaluation of Audit Evidence

The auditor shall evaluate whether analytical procedures that are performed when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud.

When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence.

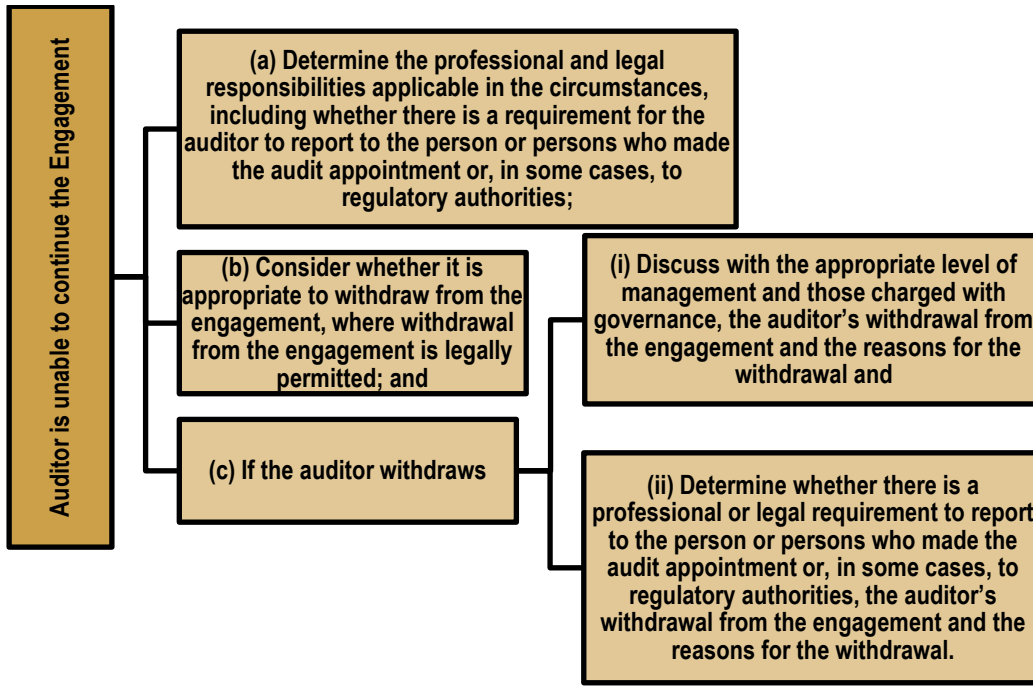
If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re- evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.

When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor shall evaluate the implications for the audit.

2.13 Auditor is Unable to Continue the Engagement

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall: -

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2.14 Management Representations

The auditor shall obtain written representations from management and, where applicable, those charged with governance that: -

(a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;

(b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;

(c) They have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving management, employees who have significant roles in internal control or others where the fraud could have a material effect on the financial statements; and

(d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

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2.15 Communications to Management and with Those Charged With Governance

If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving management, employees who have significant roles in internal control or others where the fraud results in a material misstatement in the financial statements, the auditor shall communicate these matters to those charged with governance on a timely basis.

If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.

The auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities.

2.16 Communications to Regulatory and Enforcement Authorities

If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. For example, in case of audit of banks, the auditor has a statutory duty to report the occurrence of fraud to the supervisory authorities, i.e. RBI.

Also, in some entities the auditor may have a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action. In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation.

2.17 Documentation

The auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required shall include: -

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(a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and

(b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

The auditor's documentation of the responses to the assessed risks of material misstatement required shall include: -

(a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and

(b) The results of the audit procedures, including those designed to address the risk of management override of controls.

The auditor shall document communications about fraud made to management, those charged with governance, regulators and others.

When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall document the reasons for that conclusion.

TEST YOUR UNDERSTANDING 1

My Décor Limited, presently engaged in manufacturing of fabrics, wants to set up a new plant for manufacturing of special kind of fabric providing an altogether different texture and feel. This kind of fabric has become a hit with retail customers. The company needs to set up plant for manufacturing the above kind of fabric involving huge capital outlays to stay competitive in the market.

You are auditor of the company and find that company's revenue has increased in financial year 2023-24 to ₹ 1000 crore from ₹ 750 crore in last year. By the time, you started the audit, there was no change in plant capacity and information regarding need to set up new plant has become known to you during inquiry of company's personnel.

Discuss, how you should proceed to deal with above situation, as auditor of the company, paying special attention to risk of material misstatement due to fraudulent financial reporting?

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TEST YOUR UNDERSTANDING 2

CA Ridhima, internal auditor of Track Store Limited, has pointed out following deficiencies in internal control of the company, in her reports: -

[i] Receivables are not reconciled at stipulated intervals.

[ii] Customers are provided a credit limit based upon their track record. However, no review of customer credit limits is undertaken at required intervals.

The statutory auditor of the company finds that no action has been taken by the company on the said deficiencies pointed out in reports of internal auditor.

What does above situation indicate to statutory auditor of company?

3. SA 250 "CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS"

SA 250 deals with auditor's responsibility to consider laws and regulations when performing an audit of financial statements. However, it does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

The requirements in this SA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations.

3.1 Effect of Laws and Regulations on Financial Statements of an Entity

The effect on the financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements.

Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance

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with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

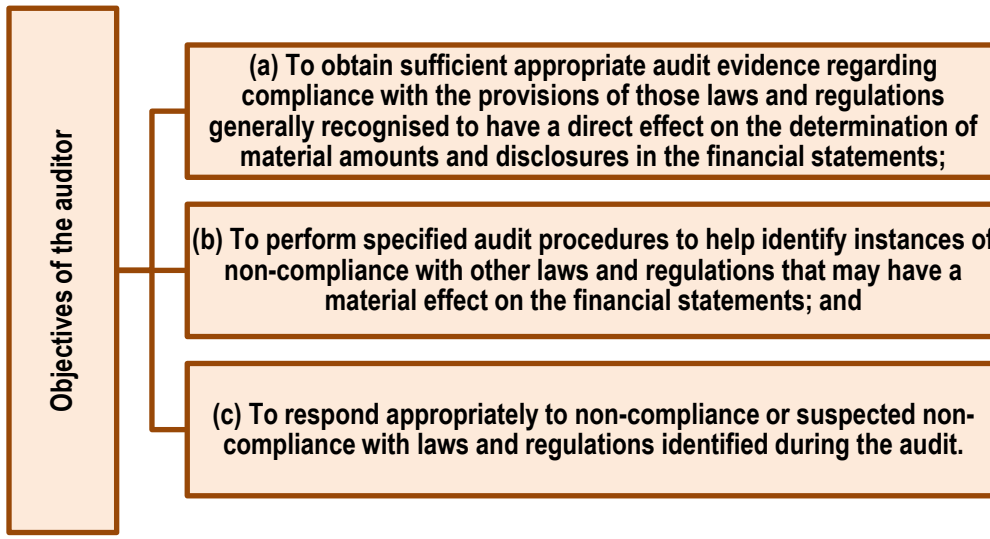
3.2. Objectives of auditor in accordance with SA 250

The objectives of the auditor in accordance with SA 250 are: -

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.



3.3 Responsibility of Management for Compliance with Laws and Regulations

It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

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The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations: -

- **Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.**
- **Instituting and operating appropriate systems of internal control.**
- **Developing, publicising and following a code of conduct.**
- **Ensuring employees are properly trained and understand the code of conduct.**
- **Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.**
- **Engaging legal advisors to assist in monitoring legal requirements.**
- **Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.**

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to an internal audit function, an audit committee, a compliance function.

3.4 Responsibility of the Auditor

The auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following: -

There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.	**Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.**	**Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.**

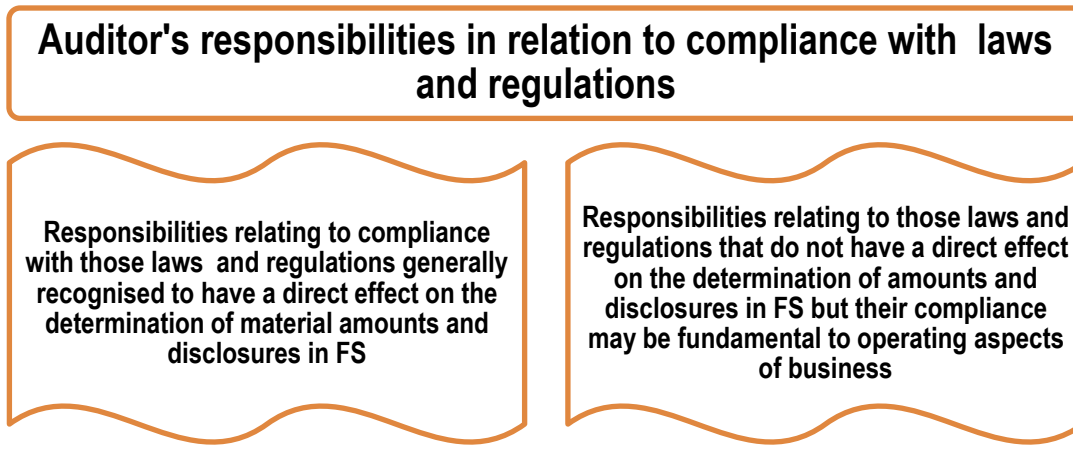
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Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognise the non-compliance.

SA 250 distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows: -

(a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws and

(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations). Non-compliance with such laws and regulations may, therefore, have a material effect on the financial statements.



For the compliance with provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements, the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations.

For other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, the auditor's responsibility is limited to undertaking specified audit

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procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

The auditor is to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining professional skepticism throughout the audit, is important in this context, given the extent of laws and regulations that affect the entity.

The Auditor's consideration of compliance with laws and regulations

As part of obtaining an understanding of the entity and its environment, the auditor shall obtain a general understanding of: -

(a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(b) How the entity is complying with that framework.

The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements. Such laws, for example, could relate to form and content of financial statements or industry- specific financial reporting issues.

The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity. Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern.

For example: Non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with

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capital or investment requirements). An NBFC might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under RBI Act and if its Net Owned Funds are less than the amount specified by the RBI in this regard.

There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures as stated above are directed to bringing to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

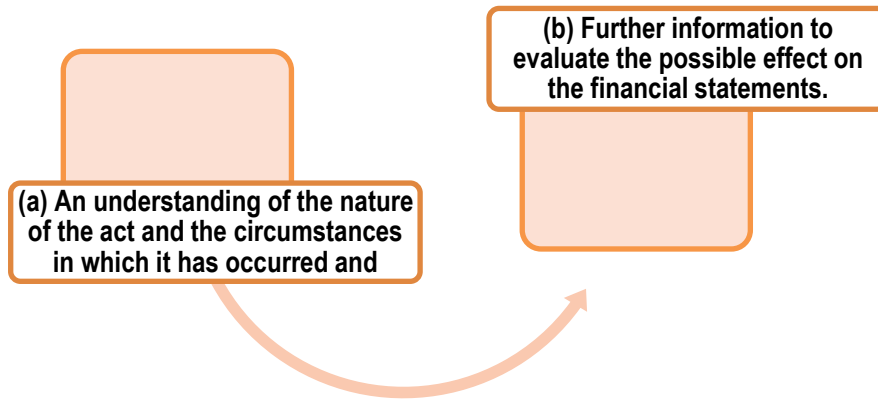
Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

3.5 Audit Procedures when Non-Compliance is Identified or Suspected

If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain:



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If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.

If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.

3.6 Reporting of Identified or Suspected Non-Compliance

(A) Reporting non-compliance to Those Charged with Governance

Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor, the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

If, in the auditor's judgment, the non-compliance referred to above is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

(B) Reporting non-compliance in the Auditor's Report on the Financial Statements

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705, express a qualified or adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified

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opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with SA 705.

(C) Reporting non-compliance to Regulatory and Enforcement Authorities

If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

3.7 Documentation

The auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.

TEST YOUR UNDERSTANDING 3

FAS Insurance Brokers Limited is a leading online insurance intermediary. During the year, Director General of GST Intelligence (DGGI) has issued notice to the company for allegedly creating fictitious invoices for "marketing and sales services" amounting to ₹ 50 crores in favour of non-life insurance companies. The premises of company were also searched during the year by DGGI officials. The matter was also informed to IRDAI by DGGI for violation of norms and regulations in this regard.

Does above situation has any bearing on your responsibilities as statutory auditor of the company? Outline briefly in context of possible non-compliance with laws by the company.

4. SA 260 "COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE"

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

Who are "Those charged with governance"?

"Those charged with governance" denote the person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes those overseeing the financial reporting process. For some

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entities, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

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

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

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

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

Significance of Communication with Those charged with governance

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

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

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

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

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4.1 Objectives of Auditor in Accordance with SA 260

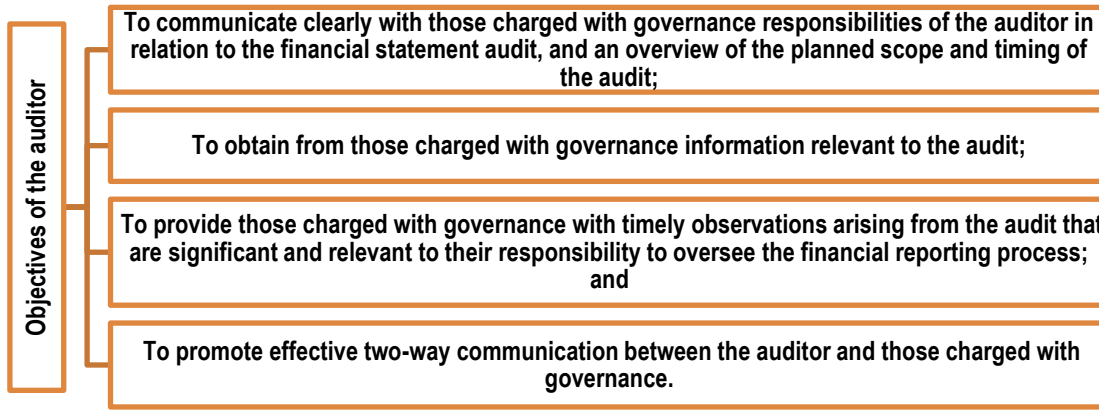
The objectives of the auditor are: -

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

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

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

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



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

4.2 Matters to be Communicated by the Auditor

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

[a] The auditor's responsibilities in relation to the financial statement audit

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

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

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

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The auditor's responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement. Law, regulation or the governance structure of the entity may require those charged with governance to agree the terms of the engagement with the auditor. When this is not the case, providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them.

[b] Planned scope and timing of the audit

Communication regarding the planned scope and timing of the audit may: -

- Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures and
- Assist the auditor to understand better the entity and its environment.

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

Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they require special audit consideration. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Care is necessary when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

[c] Significant findings from the audit

The auditor shall communicate with those charged with governance: -

(i) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

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When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

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

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

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

(2) Written representations the auditor is requesting

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

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

The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

Significant difficulties encountered during the audit may include such matters as: -

- **Significant delays by management, the unavailability of entity personnel, or an unwillingness by management to provide information necessary for the auditor to perform the auditor's procedures.**
- **An unreasonably brief time within which to complete the audit.**
- **Extensive unexpected effort required to obtain sufficient appropriate audit evidence.**
- **The unavailability of expected information.**
- **Restrictions imposed on the auditor by management.**
- **Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.**

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In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.

Significant matters that were discussed, or subject to correspondence with management may include such matters as: -

- **Significant events or transactions that occurred during the year.**
- **Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.**
- **Concerns about management's consultations with other accountants on accounting or auditing matters.**
- **Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.**
- **Significant matters on which there was disagreement with management, except for initial differences of opinion because of incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information.**

The agreed terms of the audit engagement are required to be recorded in an audit engagement letter or other suitable form of written agreement and include, among other things, reference to the expected form and content of the auditor's report. Communication in this respect is intended to inform those charged with governance about circumstances in which the auditor's report may differ from its expected form and content or may include additional information about the audit that was performed.

Circumstances in which the auditor is required or may otherwise consider it necessary to include additional information in the auditor's report in accordance with the SAs, and for which communication with those charged with governance is required, include when: -

- The auditor expects to modify the opinion in the auditor's report in accordance with SA 705.
- A material uncertainty related to going concern is reported in accordance with SA 570.
- Key audit matters are communicated in accordance with SA 701.
- The auditor considers it necessary to include an Emphasis of Matter paragraph or Other Matter paragraph in accordance with SA 706 or is required to do so by other SAs.
- The auditor has concluded that there is an uncorrected material misstatement of the other information in accordance with SA 720.

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In such circumstances, the auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate a discussion of how such matters will be addressed in the auditor's report.

4.3 Communication of Auditor's Independence in Case of Listed Entities

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

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

(b) (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and (ii) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

The Communication Process

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

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

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

Adequacy of the Communication Process

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

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4.4 Documentation

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

TEST YOUR UNDERSTANDING 4

CA Vallabh Sundar is auditor of a leading private sector bank. *"IT Systems and controls"* is under his consideration to be reported as *"Key audit matter"* in audit report of the bank due to high level of automation and complexity of the IT architecture and its impact on the financial reporting system.

At what time he should communicate such identified *"Key audit matter"*? What are relevant considerations in this regard and their usefulness?



5. SA 299 "JOINT AUDIT OF FINANCIAL STATEMENTS"

SA 299 lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200. It deals with the special considerations in carrying out audit by joint auditors.

However, it does not deal with the relationship between a principal auditor who is appointed to report on the financial statements of an entity and another auditor who is appointed to report on the financial statements of one or more component (divisions, branches, subsidiary, joint venture, associates, other entity) included in the financial statements of the entity.

What is joint audit of financial statements?

A joint audit is an audit of financial statements of an entity by two or more auditors appointed with the objective of issuing the audit report. Such auditors are described as joint auditors.

The practice of appointing more than one auditor to conduct the audit of large entities has been in vogue for a long time, sometimes voluntarily by the shareholders or sometimes due to the requirements of laws or regulations. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity.

For example, section 139(3) of the Companies Act, 2013 provides that members of a company may resolve to provide that the audit shall be conducted by more than one auditor.

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5.1 Objectives in accordance with SA 299

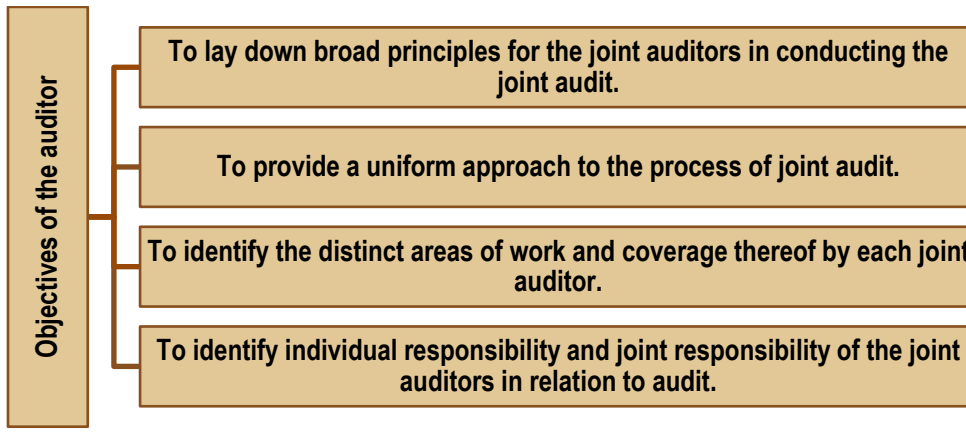
The objectives in accordance with SA 299 are as under: -

(a) To lay down broad principles for the joint auditors in conducting the joint audit.

(b) To provide a uniform approach to the process of joint audit.

(c) To identify the distinct areas of work and coverage thereof by each joint auditor.

(d) To identify individual responsibility and joint responsibility of the joint auditors in relation to audit.



5.2 Audit planning, Risk Assessment and Allocation of Work

The engagement partner and other key members of the engagement team from each of the joint auditors shall be involved in planning the audit. Overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan shall be established jointly.

Prior to the commencement of the audit, the joint auditors shall discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors shall: -

(a) Identify division of audit areas and common audit areas amongst the joint auditors that define the scope of the work of each joint auditor. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

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(b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required
(c) Consider and communicate among all joint auditors the factors that, in their professional judgment, are significant in directing the engagement team's efforts
(d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other or similar engagements performed earlier by the respective engagement partner for the entity is relevant.
(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

At this stage, risks of material misstatement need to be considered and assessed by each of the joint auditors and shall be communicated to other joint auditors, and documented, whether pertaining to the overall financial statements level or to the area of allocation among the other joint auditors.

The joint auditors shall discuss and document the nature, timing, and the extent of the audit procedures for common and specific allotted areas of audit to be performed by each of the joint auditors and the same shall be communicated to those charged with governance.

The joint auditors shall obtain common engagement letter and common management representation letter.

After identification and allocation of work among the joint auditors, the work allocation document shall be signed by all the joint auditors and the same shall be communicated to those charged with governance of the entity.

The documentation of allocation of work helps in avoiding any dispute or confusion which may arise among the joint auditors regarding the scope of work to be carried out by them. Further, the communication of allocation of work to the entity helps in avoiding any dispute or confusion which may arise between the entity and the joint auditors.

5.3 Responsibility and Co-ordination among Joint Auditors

The audit process involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility.

In respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the

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separate and specific responsibility of each joint auditor to obtain information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by said joint auditor. The joint auditors shall have proper coordination and rationality wherever required.

All the joint auditors shall be jointly and severally responsible for: -

(a) the audit work which is not divided among the joint auditors and is carried out by all joint auditors

(b) decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors.

(c) matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors

(d) examining that the financial statements of the entity comply with the requirements of the relevant statutes

(e) presentation and disclosure of the financial statements as required by the applicable financial reporting framework

(f) ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI.

Where, in the course of the audit, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

It shall be the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the areas of work allocated to said joint auditor. It is the individual responsibility of each joint auditor to study and evaluate the prevailing system of internal control and assessment of risk relating to the areas of work allocated to said joint auditor.

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As regards decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors, all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing and extent of the audit procedures agreed upon among them, proper execution of these audit procedures is the individual responsibility of the joint auditor concerned.

5.4 Audit Conclusion and Reporting

The joint auditors are required to issue common audit report, however, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to the separate audit report(s) issued by the other joint auditor(s). Further, separate audit report shall also make reference to the audit report issued by other joint auditors. Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

Each Joint Auditor is entitled to assume that: -

- **(a) The other joint auditors have carried out their part of the audit work and the work has actually been performed in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner.**
- **(b) The other joint auditors have brought to said joint auditor's notice any departure from applicable financial reporting framework or significant observations that are relevant to their responsibilities noticed in the course of the audit.**

Where financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and regulatory requirements and present a true and fair view of the state of affairs and of the results of operations of the division/branch concerned.

Before finalizing their audit report, the joint auditors shall discuss and communicate with each other their respective conclusions that would form the content of the audit report.

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5.5 Communication with Those Charged with Governance

When the joint auditors expect to modify the opinion in the auditor's report, the joint auditors shall communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification to ensure compliance with SA 705. If the joint auditors expect to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the joint auditors shall communicate with those charged with governance regarding this expectation and the proposed wording of this paragraph to ensure compliance with SA 706.

TEST YOUR UNDERSTANDING 5

Four audit firms viz. GPR & Co., MKS & Co., CY & Associates and DES & Associates have been appointed for conducting statutory audit of KNB Bank, a public sector bank in accordance with regulatory guidelines. The professional work was divided by audit firms on the basis of zones of bank. However, work relating to "IT Systems and controls" was not allocated by them due to its very nature.

While planning for the above common work area, it was decided to test IT general controls, application controls and IT dependent manual controls. Planned key audit procedures relating to this common area also included testing design and operating effectiveness of controls over "computer operations including back-up, batch-processing and data centre security".

The actual audit procedures pertaining to "testing controls over batch processing" were performed by team of DES & Associates. In case work in relation to above audit procedures is not performed professionally by DES & Associates, discuss where responsibility for such lapses would lie in line with SA 299?

6. SA 402 "AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION"

SA 402 deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies SA 315 and SA 330 in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

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What is a Service organization?

- Service organisation is a third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting. User entity is an entity that uses a service organisation and whose financial statements are being audited.

Who is a service auditor?

- Service auditor is an auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation. User auditor is an auditor who audits and reports on the financial statements of a user entity.

Many entities outsource aspects of their business to organisations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions, such as the tax compliance function. Many of the services provided by such organisations are integral to the entity's business operations; however, not all those services are relevant to the audit.

When services provided by a service organization are relevant to the audit of a user entity's financial statements?

Services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets.

A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following: -
(a) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements
(b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements
(c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions

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(d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements
(e) The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures and
(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments

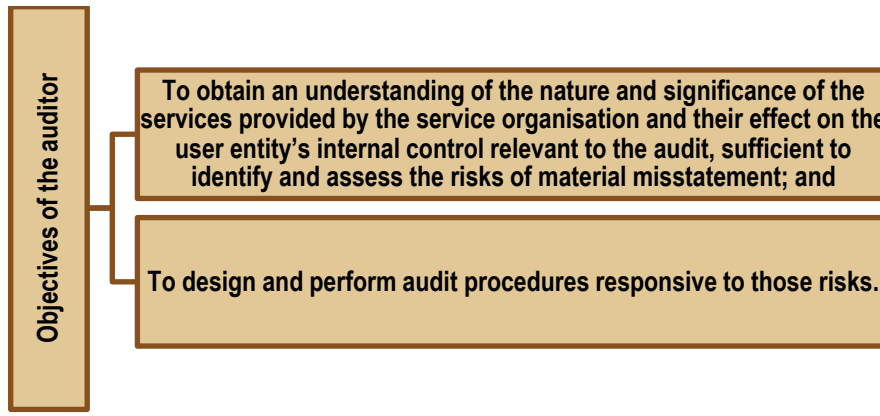
The nature and extent of work to be performed by the user auditor regarding the services provided by a service organisation depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.

6.1 Objectives of User Auditor in accordance with SA 402

The objectives of the user auditor, when the user entity uses the services of a service organisation, are:-

(a) To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and

(b) To design and perform audit procedures responsive to those risks.



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6.2 Type 1 report and Type 2 report

Type 1 report is a report that comprises: -

(i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date; and

(ii) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

Type 2 report is a report that comprises: -

(i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and

(ii) A report by the service auditor with the objective of conveying reasonable assurance that includes: -

a. The service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and

b. A description of the service auditor's tests of the controls and the results thereof.

6.3 Obtaining an Understanding of the Services

1. **Obtaining an understanding of the services provided by a service organisation, including internal control:** When obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including: -

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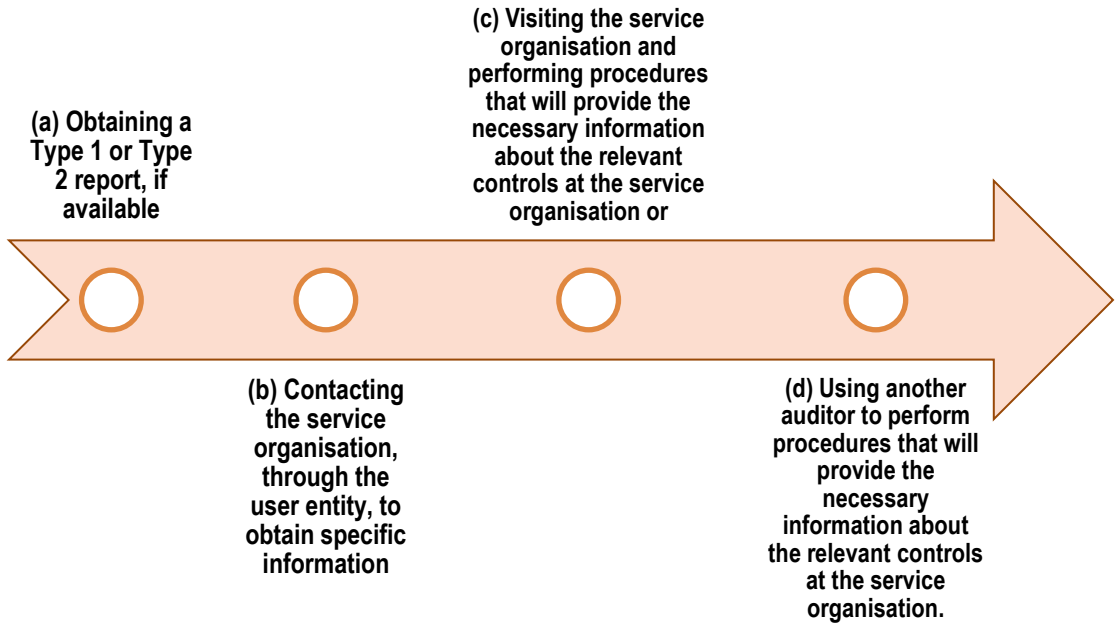
(a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control. Information on nature of services provided by a user organization may be available from sources such as user manuals, contract between the user entity and service organization, reports by service auditors etc.
(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation. In certain situations, the transactions processed and the accounts affected by the service organisation may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.
(c) The degree of interaction between the activities of the service organisation and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organisation. For example, a high degree of interaction exists between the activities of the user entity and those at the service organisation when the user entity authorises transactions and the service organisation processes and does the accounting for those transactions
(d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

2. **When obtaining an understanding of internal control relevant to the audit in accordance with SA 315, the user auditor shall evaluate the design and implementation of relevant controls** at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation.

3. **The user auditor shall determine whether a sufficient understanding of the nature and significance of the services** provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.

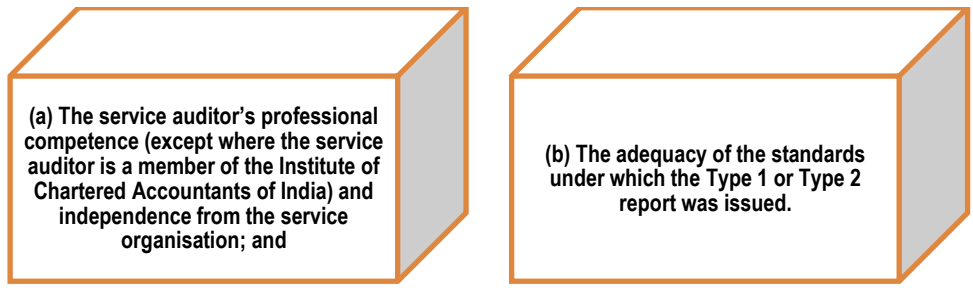
4. **If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures: -**

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6.4 Using Type 1 or Type 2 Report

Using A Type 1 Or Type 2 Report to Support the User Auditor's Understanding of The Service Organisation : In determining the sufficiency and appropriateness of the audit evidence provided by a Type 1 or Type 2 report, the user auditor shall be satisfied as to: -



If the user auditor plans to use a Type 1 or Type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, the user auditor shall:

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(a) Evaluate whether the description and design of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;

(b) Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and

(c) Determine whether complementary user entity controls identified by service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Complementary user entity controls refer to controls that the service organisation assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.

6.5 Responding to the Assessed Risks of Material Misstatement

In responding to assessed risks in accordance with SA 330, the user auditor shall: -

(a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,

(b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

6.6 Tests of Controls

When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures: -

(a) Obtaining a Type 2 report, if available;

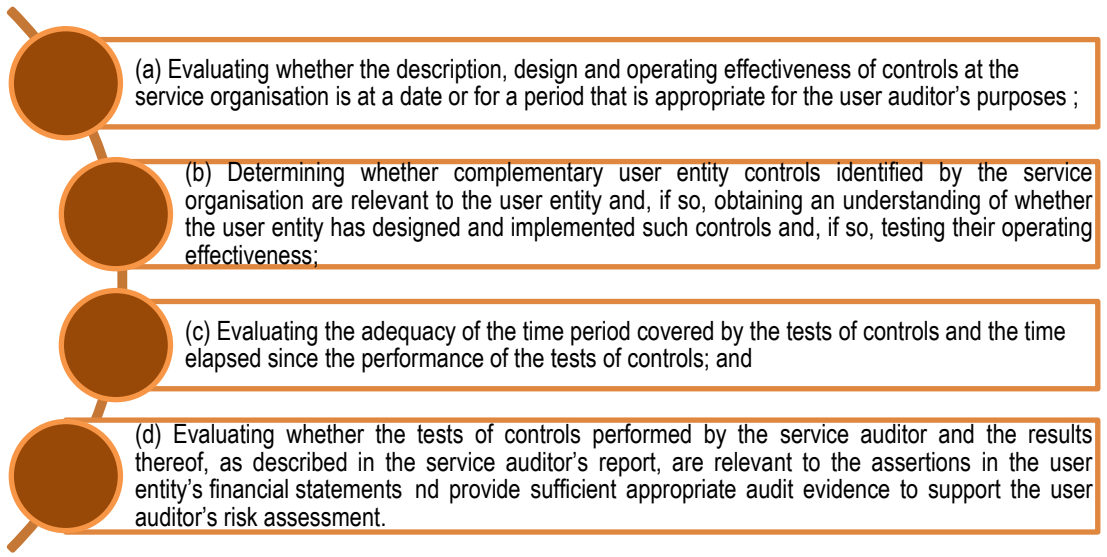
(b) Performing appropriate tests of controls at the service organisation; or

(c) Using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.

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Using a Type 2 report as audit evidence that controls at the service organisation are operating effectively

If, the user auditor plans to use a Type 2 report as audit evidence that controls at the service organisation are operating effectively, the user auditor shall determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by:



6.7 Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in relation to Activities at the Service Organisation

The user auditor shall inquire of management of the user entity whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report.

6.8 Reporting by the User Auditor

The user auditor shall modify the opinion in the user auditor's report in accordance with SA 705 if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements.

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The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion.

If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion.

Key Takeaways

- Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
- SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Its requirements assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.
- Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.
- The effect on the financial statements of laws and regulations varies considerably. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements.
- Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.
- SA 250 deals with auditor's responsibility to consider laws and regulations when performing an audit of financial statements.
- Communication from auditor is important with those charged with governance. SA 260 deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.
- A joint audit is an audit of financial statements of an entity by two or more auditors appointed with the objective of issuing the audit report. Such auditors are described as joint auditors.

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- SA 299 lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200. It deals with the special considerations in carrying out audit by joint auditors.
- Service organisation is a third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting. User entity is an entity that uses a service organisation and whose financial statements are being audited.
- SA 402 deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM: SCAN ME !



TEST YOUR KNOWLEDGE

Theoretical Questions

1. *A, B and C are joint auditors of a company. B is of the opinion that there are material misstatements in financial statements of a company which, if accounted for, would turn profit reflected in financial statements for ₹ 25 crore to a loss of ₹ 5 crore. He, therefore, wants an adverse opinion to be expressed in audit report. However, A and B do not concur with his views and are inclined to accept management's version. Is B required to go by majority opinion of 2-1?*
2. *CA Shelly Goel is offered appointment as auditor of Rute Limited, a listed company. The audit committee of the company wants her to justify independence in relation to company through proper communication. Although she has ensured that there are no threats to her independence, she feels requirement of audit committee to be beyond its purview. What is your opinion in this regard?*

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3. *You are auditor of a social media company. Of late, government has tightened noose around companies operating in this segment by bringing in a maze of regulatory legislations to protect interests of users. How you can proceed to verify that company is compliant with new regulatory requirements? Besides, what does above situation underscore to you as an auditor?*

4. *Discuss why the potential effects of inherent limitations of an auditor's ability to detect material misstatements described in SA 200 are far greater in respect of non-compliance with laws and regulations?*

5. *MN & Associates are the statutory auditors of ABC Ltd. for the FY 2023-24. During the course of audit, the engagement partner, Mr. Manohar notices a misstatement resulting from a suspected fraud that brings into question the audit team's ability to continue performing the audit. How should the audit team deal with the situation?*

6. *CA Anand is the engagement partner for the audit assignment of NHT Ltd. engaged in manufacture of Iron and Steel bars. The company has its plants in the state of Sikkim. While verifying the wages record of the company, CA Anand found that maximum of the labour employed in the plants of the company was child labour. He questioned the management of the company about the same to which the management replied that looking into the compliance of such law is outside his scope of financial audit. Give your comments with respect to such situation.*

7. *Magnet Interiors Ltd. is a listed company engaged in the manufacture of office furniture. The company has its activities divided into four geographic regions. The company has appointed two joint auditors, namely, AB & Co. and CD & Co. to conduct the joint audit of the financial statements of the company for the year ending 31-03-2024. The engagement partners from both the firms, CA Amar and CA Chetanya along with their audit teams had a meeting to discuss the areas of the work to be divided and their respective responsibilities. Explain the responsibilities of the joint auditors with respect to such joint audit.*

8. *MNO Ltd. gets its accounting data processed by a service organisation. CA Riya is the statutory auditor of MNO Ltd. CA Riya wants to obtain an understanding as to how MNO Ltd. is using the services of the service organisation. What all understanding should she obtain?*

9. *UVW & Associates are the statutory auditors of Moon Ltd., a listed company, for the financial year 2023-24. CA Udhav is the engagement partner for the audit assignment. He was of the understanding that as per the requirement of one of the SAs he has a responsibility to communicate following matters to those charged with governance:*

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(a) The auditor's responsibilities in relation to the financial statement audit.

(b) Planned scope and timing of the audit.

(c) Auditor independence

Which of the matters is not included in the list prepared by CA Udhav. Discuss such matters in detail.

10. ***Studio Ltd. appointed RST & Associates and XYZ & Co. as joint auditors for conducting the audit for the year ending on 31st March 2024. During the audit, it was observed that there is a significant understatement in the value of trade receivables. The trade receivable valuation work was looked after by RST & Associates, however, there was no documentation outlining the division of the work between the joint auditors. Comment on the above situation with respect to the allocation of responsibilities among joint auditors as per relevant Standards on Auditing.***

11. ***During the audit of Indo limited, CA Harish observed that processing of accounting data was given to a third party on account of certain considerations like cost reduction, own computer working to full capacity. Indo Limited used a service organisation to record transactions and process related data. What factors should CA Harish consider regarding the nature and extent of activities undertaken by service organisation so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk. Discuss with reference to the relevant Standards on Auditing.***

12. ***Happy Hospital is a very renowned hospital for Orthopedic Surgeries in Mumbai having sophisticated infrastructure. Happy Hospital has started using a novice system which includes complete record of Indoor Patient i.e. their diagnosis, their treatment, their medications, their billings, and receipts thereon which is developed and managed by CT Contractors. CA Z is a statutory auditor of Happy Hospital. CA Z came to know about this system while auditing. CA Z is concerned whether the controls at CT Contractors Associates are operating effectively or not. For this purpose, CA Z demanded from CT Contractors, an assurance report from a practicing chartered accountant about their opinion on the description of CT Contractor's system, and the effectiveness of the control. Which type of report should be obtained by CA Z in terms of relevant Standard on Auditing? What aspects are to be considered by CA Z in using such assurance report as audit evidence that controls at CT Contractors are operating effectively?***

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13. ***FAB Limited is availing the services of Atiya Private Limited for its payroll operations. Payroll cost accounts for 63% of total cost for FAB Limited. Atiya Limited has provided the type 2 report as specified under SA 402 for its description, design, and operating effectiveness of control.***

Atiya Private Limited has also outsourced a material part of payroll operation M/s RST & Associates in such a way that M/s RST & Associates is sub-service organization to FAB Limited. The Type 2 report which was provided by Atiya Private Limited was based on carve-out method as specified under SA 402.

CA Akram while reviewing the unmodified audit report drafted by his assistant found that, a reference has been made to the work done by the service auditor. CA Akram hence asked his assistant to remove such reference and modify report accordingly.

Comment whether CA Akram is correct in removing the reference of the work done by service auditor?

14. ***Arihant Ltd. was engaged in the business of owning and managing hotels and resorts, selling tourism packages and performing airline bookings for corporate and individuals. It appointed Upadhyay & Co. as its statutory auditor for the financial year 2023-24. While planning the audit, the audit team decided that the risk of improper revenue recognition from hotel business should not be treated as a fraud risk. This conclusion was based on the assessment of earlier years, wherein no fraud was identified in revenue recorded from such business. While testing the internal financial controls over the process of revenue recognition, it was identified that the controls are not properly designed to mitigate the risk of fraud and risk of improper revenue recognition. As a result, the audit team decided to perform additional substantive testing. However, the audit team still were to the conclusion that there is no risk of fraud in revenue recognition. During the course of substantive testing, it was identified that the management did not account for revenue received from corporate hotel bookings amounting to ₹ 43 crore. These amounts were partially received in the company's bank accounts and partially received in the CFO's personal account. The amounts received in the bank account of the company were disclosed as advances received against the future bookings. In the light of above scenario, kindly guide the statutory auditors with respect to their responsibility relating to fraud in an audit of a financial statement.***

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Answers to Test Your Understanding:

1. The given situation highlights need for the company to set up new plant for manufacturing of special kind of fabric to stay competitive in the market. Setting up of such plant involves huge capital outlays which could entail financing arrangements. Therefore, excessive pressure exists for management to be involved in fraudulent financial reporting. In such a situation, management may be tempted to inflate its revenues to show rosy picture. It is a fraud risk factor and needs to be evaluated by the auditor.

The revenues of the company have jumped from ₹ 750 crore in last year to ₹ 1000 crore in year 2023-24 without any change in plant capacity. The auditor may consider above said fraud risk factor for assessing risk of material misstatement due to fraud.

In case of auditor assessing risk of material misstatement due to fraudulent financial reporting, audit procedures to address such risk like performing substantive analytical procedures relating to revenue, use of computer assisted audit techniques to identify unusual revenue transactions and testing controls pertaining to revenue transactions need to be performed.

2. Management failing to remedy known significant deficiencies in internal control on a timely basis is a fraud risk factor for misstatements arising from fraudulent financial reporting.

When management does not correct significant deficiencies in internal control on a timely basis, it reflects an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act.

Failure to rectify known control deficiencies pertaining to reconciliation of receivables and review of customer credit limits has the potential to fraud. Lack of timely reconciliation of receivables may lead to intentional misstatements. Further, non-reviewing customer limit may lead to grant of credit beyond creditworthiness of customers. It may result in intentional tying up of company's funds with risky customers due to collusion.

The above situation is a fraud risk factor for fraudulent financial reporting.

3. When the auditor becomes aware of the existence of or has information about investigations by government departments and regulatory organizations, it may be an indication of non-compliance with laws and regulations.

In the instant case, notice has been served upon the company by DGGI for allegedly creating fictitious invoices in guise of providing *"marketing and sales services"* for ₹ 50 crores. Issuing an invoice without supply of services is a serious offence under GST laws and it could involve

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penalties and imprisonment. Such suspected non-compliance may have a direct effect on financial statements.

The matter has also been informed to regulator i.e. IRDAI. Violation of IRDAI regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: -

(a) An understanding of the nature of the act and the circumstances in which it has occurred and

(b) Further information to evaluate the possible effect on the financial statements.

If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.

If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

4. SA 260 requires the auditor to communicate with those charged with governance on a timely basis.

SA 701 states that the appropriate timing for communications about key audit matters will vary with the circumstances of the engagement. However, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit, and may further discuss such matters when communicating about audit findings. Doing so may help to alleviate the practical challenges of attempting to have a robust two-way dialogue about key audit matters at the time the financial statements are being finalized for issuance.

Communication with those charged with governance enables them to be made aware of the key audit matters that the auditor intends to communicate in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary. The auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate this discussion.

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Communication with those charged with governance recognizes their important role in overseeing the financial reporting process, and provides the opportunity for those charged with governance to understand the basis for the auditor's decisions in relation to key audit matters and how these matters will be described in the auditor's report. It also enables those charged with governance to consider whether new or enhanced disclosures may be useful in light of the fact that these matters will be communicated in the auditor's report.

5. In respect of common areas, the joint auditors are only responsible for appropriateness of nature, timing and extent of planned audit procedures agreed among them. The responsibility of individual execution lies with concerned joint auditor.

In the instant case, audit procedures relating to testing design and operating effectiveness of controls over computer operations including back-up, batch-processing and data center security have been planned jointly as it is a common area.

However, audit procedures relating to testing controls over batch processing were actually performed by team of DES & Associates although these were planned jointly. In case of any lapses in performing such procedures, DES & Associates would be responsible.

Hints /Answers to Theoretical Questions:

1. Where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement. Therefore, B is not required to go by majority opinion of 2-1.

In such circumstances, the audit report issued by the joint auditors shall make a reference to the separate audit report issued by the other joint auditor. Further, separate audit report shall also make reference to the audit report issued by other joint auditors. Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

2. As required in SA 260, in the case of listed entities, the auditor shall communicate with those charged with governance: -

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

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(b) i. All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor and

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

Further, as per the Companies Act, 2013 requires audit committee to review and monitor auditor's independence. Therefore, audit committee requiring auditor to justify her independence is well within its purview.

3. It needs to be verified that the company has put in place systems and procedures to meet with new regulatory requirements. The same can be verified by examining policies and procedures developed by company in this regard like devising appropriate system of internal control, sensitizing employees regarding new rules, engaging legal advisors etc.

Further, financial stability of the company may be threatened due to new regulatory requirements. The management may be under pressure. It is also a fraud risk factor and may need to be evaluated by auditor.

4. In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following: -

- There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

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5. During the course of audit, the engagement partner, Mr. Manohar notices a misstatement resulting from a suspected fraud that brings into question the audit team's ability to continue performing the audit. In such a situation the audit team should:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws: -

(i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

6. As per SA 250 "Considerations of Laws and Regulations in an Audit of Financial Statements", the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework.

For the compliance with provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements, the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations.

For other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

In the instant case, maximum of the labour employed in the plants of the company was child labour. When CA Anand questioned the management of the company about the same, the

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management replied that looking into the compliance of such law is outside his scope of financial audit. Such reply by the management is not acceptable as such situation may have a material effect on the financial statements. Therefore, CA Anand should ensure as to whether any penal provisions will be there for non- compliance of such law and also whether the same has been duly disclosed by the company. If CA Anand concludes that such non-compliance has a material effect on the financial statements and the same has not been adequately reflected in the financial statements by the company, he shall express an adverse or a qualified opinion on the financial statements.

7. As per SA 299 "Joint Audit of Financial Statements", in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by said joint auditor. The joint auditors shall have proper coordination and rationality wherever required.

All the joint auditors shall be jointly and severally responsible for: -

(a). the audit work which is not divided among the joint auditors and is carried out by all joint auditors

(b). decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors.

(c). matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors

(d). examining that the financial statements of the entity comply with the requirements of the relevant statutes

(e). presentation and disclosure of the financial statements as required by the applicable financial reporting framework

(f). ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI.

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Where, in the course of the audit, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

It shall be the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the areas of work allocated to said joint auditor. It is the individual responsibility of each joint auditor to study and evaluate the prevailing system of internal control and assessment of risk relating to the areas of work allocated to said joint auditor.

As regards decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors, all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing and extent of the audit procedures agreed upon among them, proper execution of these audit procedures is the individual responsibility of the joint auditor concerned.

8. When obtaining an understanding of MNO Ltd. (user entity) in accordance with SA 315, CA Riya shall obtain an understanding of how MNO Ltd. uses the services of a service organisation in its operations, including: -

(a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control. Information on nature of services provided by a user organization may be available from sources such as user manuals, contract between the user entity and service organization, reports by service auditors etc.

(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation. In certain situations, the transactions processed and the accounts affected by the service organisation may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

(c) The degree of interaction between the activities of the service organisation and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organisation. For example, a high degree of interaction exists between the activities of the user entity and those at the service organisation when the user entity

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authorises transactions and the service organisation processes and does the accounting for those transactions

(d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

9. SA 260 "Communication with Those Charged with Governance" deals with auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements. Among various matters as included by CA Udhav in his list, one of the matters that is not mentioned in the list is Significant findings from the audit. With respect to such matter, the auditor shall communicate with those charged with governance: -

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

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

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

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

(ii) Written representations the auditor is requesting

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

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

The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

10. Responsibility and Co-ordination among Joint Auditors: As per SA 299, "Joint Audit of Financial Statements", where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of the work would usually be in terms of audit identifiable units or specified area. In some cases, due to

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the nature of the business entity under audit, such a division of the work may not be possible. In such situations, the division of the work may be with reference to items of assets or liabilities or income or expenditure or with reference to period of time. The division of the work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

In respect of the audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate audit of the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

(i) The audit work which is not divided among the joint auditors and is carried out by all joint auditors;

(ii) Decisions taken by all the joint auditors under audit planning phase concerning the nature, timing and extant of the audit procedure to be performed by each of the auditor;

(iii) Matters which are bought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(iv) Examining that the financial statements of the entity comply with the requirements of the relevant statute;

(v) Presentation and disclosure of financial statements as required by the applicable financial reporting framework;

(vi) Ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI;

The joint auditors shall also discuss and document the nature, timing, and the extent of the audit procedures for common and specific allotted areas of audit to be performed by each of the joint auditors and the same shall be communicated to those charged with governance. After identification and allocation of work among the joint auditors, the work allocation document shall be signed by all the joint auditors and the same shall be communicated to those charged with governance of the entity.

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Hence, in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures.

In the instant case, Studio Ltd. appointed two CA Firms RST & Associates and XYZ & Co. as joint auditors for conducting audit. As observed during the course of audit that there is a significant understatement in the value of trade receivable and valuation of trade receivable work was looked after by RST & Associates.

In view of SA 299, RST & Associate will be held responsible for the same as trade receivable valuation work was looked after by RST & Associates only. Further, there is violation of SA 299 as the division of work has not been documented.

11. *As per SA 402 "Audit Considerations relating to an Entity using a Service Organization", when obtaining an understanding of the user entity in accordance with SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment", the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:*

    (i) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;

    (ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;

    (iii) The degree of interaction between the activities of the service organisation and those of the user entity; and

    (iv) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organization.

    Based on above, while conducting the audit, CA Harish will assess the effect on the audit risk and take necessary steps.

12. *In the given scenario, CA Z, as the statutory auditor of Happy Hospital, is concerned about the effectiveness of controls at the service organization, specifically the system managed by CT Contractors. To address this concern, CT Contractors should provide a Type 2 assurance report from a practicing chartered accountant as per SA 402, "Audit*

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Considerations Relating to an Entity Using a Service Organisation". This report will offer an opinion on the description of the system in use at Happy Hospital, as well as evaluate the effectiveness of the controls implemented by CT Contractors.

Using a Type 2 report as audit evidence that controls at the service organisation are operating effectively: If, the user auditor plans to use a Type 2 report as audit evidence that controls at the service organisation are operating effectively, the user auditor shall determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by:

(a) Evaluating whether the description, design, and operating effectiveness of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;

(b) Determining whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;

(c) Evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and

(d) Evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

13. Reporting by the User Auditor: As per SA 402, "Audit Considerations Relating to an Entity Using a Service Organisation", the user auditor shall modify the opinion in the user auditor's report in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report", if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements.

The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion.

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Thus, in view of the above, contention of CA Akram in removing reference of the work done by service auditor is in order as in case of unmodified audit report, user auditor cannot refer to the work done by service auditor.

14. ***As per SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.***

In accordance with SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and SA 330, "The Auditor's Responses to Assessed Risks" the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level and assertion level.

The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property. However, when there is a complex revenue structure or when there is lack of controls on revenue recognition, then there is a high probability of fraud risk in revenue recognition.

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit.

In the current scenario, the company was earning revenue from multiple streams. Also, it was identified that the controls are not properly designed to mitigate the risk of fraud and risk of improper revenue recognition. During the year it was identified that the management did not account for revenue from corporate hotel bookings amounting to *₹ 43 crore. These amounts were partially received in the company's bank accounts and partially received in the CFO's personal account. The amounts received in the bank*

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account of the company were disclosed as advances received against future bookings.

Therefore, the auditor while performing the risk assessment procedures should consider the complexity and nature of the revenue for determining the fraud risks in revenue recognition. Also, there were no adequate controls addressing the risk of improper revenue recognition or fraud risk, the audit team rebutted the fraud risk. Moreover, the audit team should have recognised fraud risk by identifying the deficiencies of internal control over the revenue recognition process and should have treated the risk of improper revenue recognition as a significant risk. Also, as per Section 143(12), the auditor is required to report all the frauds identified during the course of the audit involving amounts above *₹ 1 crore within the prescribed time frame to the Central Government.*

(Note: Content of SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing; SA 210 Agreeing the Terms of Audit Engagements and SA 230 Audit Documentation is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.)

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CHAPTER 3

AUDIT PLANNING, STRATEGY & EXECUTION



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Know factors, benefits and considerations for establishing overall audit strategy.
- Understand the nature and extent of planning.
- Analyse the responsibility of the auditor in audit strategy and audit plan.
- Understand the process of audit execution.

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CHAPTER OVERVIEW



CA B has qualified final Chartered Accountancy exams. Plunging into the field of auditing practice after setting up his own office, he accepted audit of a company engaged in emerging *"fintech"* sector. The company relies heavily on big data and artificial intelligence. It is also expected to lean upon Blockchain technology in coming years and is working in that direction. Company is also a participant in Regulatory sandbox i.e., of live testing of new products and services under controlled environment.

While planning audit, he felt need for involvement of an expert IT specialist for gaining an insight into various IT controls and IT laws & rules in heavily tech laden company. Is such consideration a factor to be considered in establishing overall audit strategy? In case he chose to involve an expert IT specialist, would his overall responsibility as an auditor be shared in some way? Would it be prudent for him to enter into a formal agreement with the expert detailing out nature, scope and objectives of his work? Besides, he had this nagging doubt in mind over confidentiality requirements pertaining to experts. Involving experts in the exercise of understanding controls may split open the company's systems and sensitive data before him. Wouldn't it tantamount to violation of confidentiality principle of professional ethics? He was keeping his fingers crossed.

As the company and its business-both were new to him, he was keen on gaining knowledge about business of the company. Vividly remembering that knowledge of client's business is foremost requirement for developing an overall audit plan, he proceeded to gain broad regulatory requirements pertaining to *fintech* sector. Learning that not only RBI, but Ministry of Electronics and Information technology (MeitY) has also a role to play in this sector under flagship *Digital India* programme. He was also trying to understand revenue recognition practices of the industry. He also came to know that "Ombudsman scheme for digital

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transactions" for filing consumer complaints was in existence. Would such knowledge be helpful to him in understanding about the company as far as audit was concerned?

The company also has an internal audit department. He finds that the internal audit department of the company is scantily staffed and is headed by a banker retired from the post of Chief manager of a public sector bank. He didn't appear to be tech-savvy. On enquiry, he came to know that he got the job on recommendation of some government official. In these circumstances, would it be advisable for him to rely upon work performed by an internal auditor? He needed to take a decision in this regard.

1. COMMENCING AN AUDIT

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

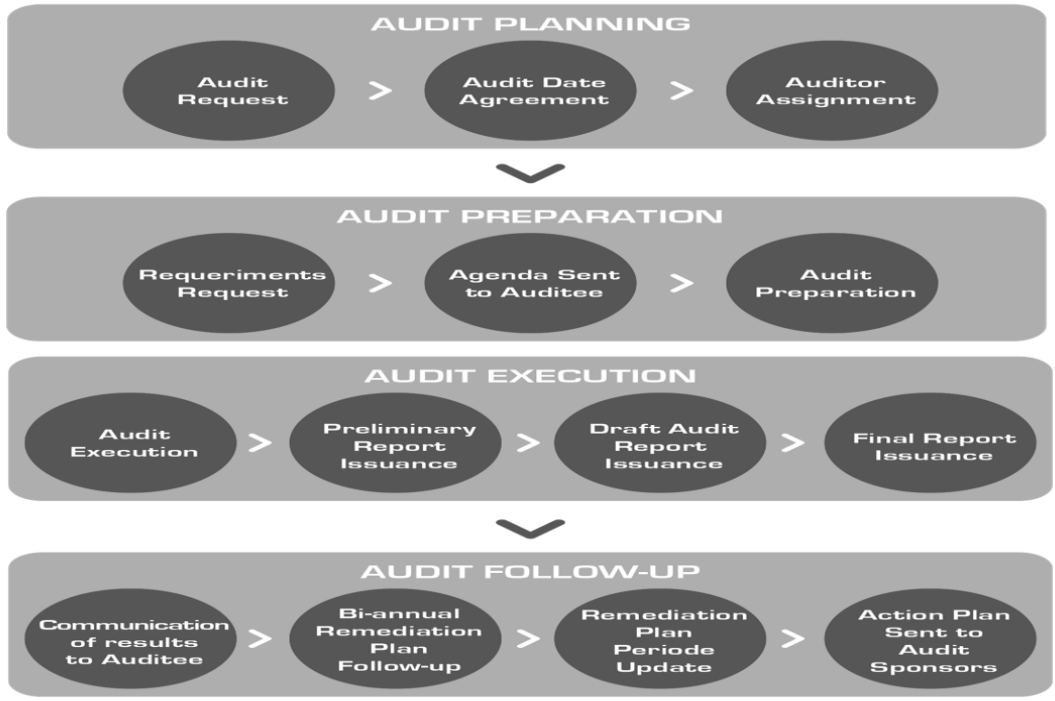


Image: Audit Planning, Preparation and Execution♣

♣ Source : Forum Auditorías

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

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

(i) Attention to Important areas.

(ii) Timely resolution of Potential Problems.

(iii) Proper Organisation and Management of Audit Engagement.

(iv) Proper Selection of Engagement Team.

(v) Direction and Supervision of Engagement Team.

(vi) Easy Coordination in work done by auditors of components and experts.

1.2 Nature and Extent of Planning

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

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

(ii) Past Experience & Expertise - The key engagement team members' previous experience & expertise also contributes towards variation in planning activities.

(iii) Change in Circumstances - Another factor contributing towards variation in planning activities is change in circumstances.

1.3 Planning - A Continuous Process

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



1. Planning includes the need to consider such matters as:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework

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applicable to the entity and how the entity is complying with that framework.

- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

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

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

Although these discussions often occur but the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters about the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit to be taken to see there is no compromise in the effectiveness of the audit. **For Example - discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.**

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

1.5 Acceptance and Continuance of Client Relationships and Audit Engagements

Acceptance and Continuance of Client Relationships and Audit Engagements are very important preliminary engagement activities. The engagement partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed and should determine that conclusions reached in this regard are appropriate.

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

(i) Performing procedures required by SA 220, "Quality Control for an Audit of Financial Statements" regarding the continuance of the client relationship and the specific audit engagement. As per the combined reading of SA 220 and SQC 1, information and procedures such as the following, assists the auditor in determining whether the

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

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

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

(ii) Evaluating compliance with ethical requirements, including independence, as required by SA 220; and

(iii) Establishing an understanding of the terms of the engagement, as required by SA 210.

1.6 Contents of an Audit Plan

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

(i) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".

(ii) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330, "The Auditor's Responses to Assessed Risks".

(iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

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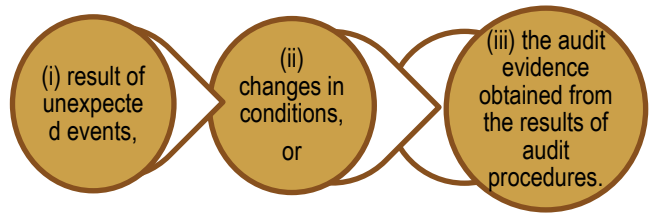
2. Planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures.

In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

1.7 Changes to Planning Decisions

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

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



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

This may be the case when information coming to the auditor differs significantly from the information when he planned the audit procedures.

3. Audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

In addition to above, there may be a possibility of change in law, notifications, government. policies which may warrant updating of overall audit strategy.

TEST YOUR UNDERSTANDING 1

XWL Limited was engaged in dealing in commodity futures trading based in Surat. CA P, based at Delhi, was auditor of the company. The auditor did not even once visit the office of the company and failed to understand the nature of business of the company. All the papers and account books were received on emails and audit was concluded.

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There were also included in his working papers checklists which had a requirement of test checking of cost of raw material consumed & cost of stores and spares. There was nothing in his working papers showing understanding of the nature of business of company. What does it reflect upon planning of audit by CA P?



2. OVERALL AUDIT STRATEGY

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

2.1 Factors while Establishing Overall Audit Strategy

Overall audit strategy would involve-

(i) **Determination of Characteristics of Audit:** Identify the characteristics of the engagement that defines its scope.

(ii) **Reporting Objectives:** Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.

(iii) **Team's Efforts:** Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.

(iv) **Considering result of preliminary engagement activities:** Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant.

(v) **Nature, timing and Extent of Resources:** Ascertain the nature, timing and extent of resources necessary to perform the engagement.

2.2 Benefits of Overall Audit Strategy

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

(i) **Employment of Qualitative Resources:** The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters like review of valuation, hedging transactions.

(ii) **Allocation of Quantity of Resources:** The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count

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

(iii) **Timing of Deployment of Resources:** When these resources are to be deployed, such as whether at an interim audit stage or at or close to key cut-off dates.

(iv) **Management of Resources:** How such resources shall be managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

2.3 Considerations in Establishing the Overall Audit Strategy

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

(a) Characteristics of the Engagement

(i) The financial reporting framework.

(ii) Industry-specific reporting requirements such as reports mandated by industry regulators.

(iii) The expected audit coverage, including the number and locations of components to be included.

(iv) The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.

(v) The extent to which components are audited by other auditors.

(vi) The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.

(vii) The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.

(viii) The effect of information technology on the audit procedures.

(ix) The availability of client personnel and data.

(b) Reporting Objectives, Timing of the Audit, and Nature of Communications

(i) The entity's timetable for reporting.

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(ii) The organization of meetings with management regarding audit work (Nature, timing and extent).

(iii) The discussion with management regarding type and timing of reports to be issued.

(iv) The discussion with management regarding communications on the status of audit work.

(v) Communication with auditors of components regarding types and timing of reports to be issued.

(vi) The nature and timing of communications among engagement team members.

(vii) Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

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

(i) The determination of materiality in accordance with SA 320.

(ii) Preliminary identification of areas where there may be a higher risk of material misstatement.

(iii) The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.

(iv) The manner in which engagement team members needs to maintain an inquisitive/ questioning mind and exercise professional skepticism and unpredictability.

(v) Results of previous audits including the identified deficiencies and action taken to address them.

(vi) The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.

(vii) Evidence of management's commitment to the design, implementation and maintenance of sound internal controls.

(viii) Volume of transactions which may determine reliance on internal control.

(ix) Importance attached to internal control.

(x) Significant business developments affecting the entity.

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(xi) Significant industry specific developments and development in the economic environment.

(xii) Significant changes in the financial reporting framework, such as changes in accounting standards.

(xiii) Other significant relevant developments, such as changes in the legal and regulatory environment affecting the entity.

(d) Nature, Timing and Extent of Resources

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

(ii) Engagement budgeting.

2.4 Documenting the Audit Plan

The auditor shall document-

(i) The overall audit strategy;

(ii) The audit plan; and

(iii) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. Documentation of these matters assists auditor as under: -

(a) **Record of Key Decisions:** The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team

(b) **Record of Nature, Timing and Extent of Risk Assessment Procedures:** The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and additional audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

(c) **Record of reasons for change in audit strategy and plan:** A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the

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planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

2.5 Relationship between the Overall Audit Strategy and the Audit Plan



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

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



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

The overall audit strategy & audit plan should take into consideration the element of materiality and its relationship with Risks & procedures to be adopted.

** Source : msp-c.com*

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3. AUDIT PROGRAMME

An audit programme is commonly prepared to allocate work to team members which may include the list of audit procedures and instructions to be followed by the member. It also estimates the duration for completing an audit task.

3.1 Formulating an Audit Programme

It is very useful for you to know how to formulate an audit programme. The programme may contain audit objectives for each area and should have sufficient detail to serve as a set of instructions to the assistants involved in the audit and as means to control the proper execution of work. It may be emphasized that a clear spelling out of audit objectives for each area is important to link up the procedures with audit objectives and to ensure a purposeful audit.

The important matters which need to be considered in this regard are:

(a) Nature of business in which the organisation is engaged: On his first appointment, the auditor should examine in detail the financial and accounting organisation of the business by visiting the client's office; by observing different stages through which documents pass before each transaction is authorised and recorded; the record that is kept and the type of books maintained.

In the case of an industrial concern, he must also visit the factory to acquaint himself with the different processes of manufacture, the quantitative records maintained and the manner in which statistics are compiled in respect of losses in process.

The auditor, therefore, should draw up the audit programme after considering the technical, financial and accounting set-up of the company.

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

(c) System of internal control and accounting procedures: The existence of a system of internal control ensures that both financial and statistical records are checked continuously; it also unearths errors, both of omission and of commission. The auditor, in framing his opinion on financial statements, needs reasonable assurance that transactions are properly authorised and recorded in the accounting records and that transactions have not been omitted. The study and evaluation of internal control helps the auditor to establish the reliance he can place on the internal controls in

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determining the nature, timing and extent of his substantive auditing procedures.

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

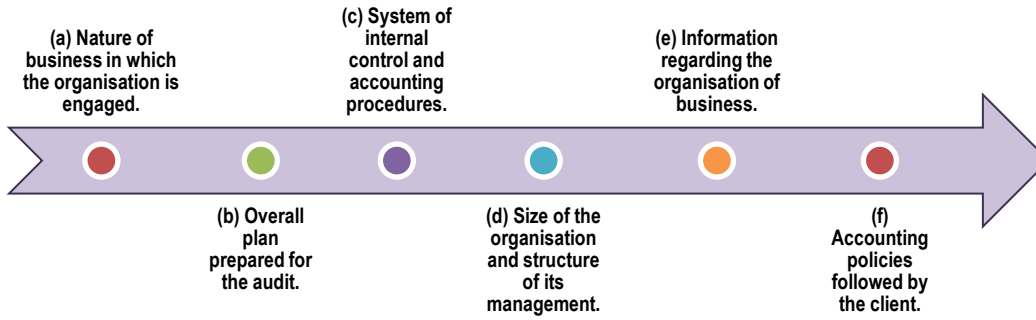
(d) Size of the organisation and structure of its management: An increase in the size of the organisation enhances the complexity of the examination of its accounting records specially when it has a number of branches, deals in several products or has a very large turnover.



5. The reports of the Comptroller and Auditor General on audit of accounts of Public Enterprises show that some of them have a very poor system of internal controls. In such cases, the magnitude of the tasks of the auditor increases considerably.

(e) Information as regards organisation of the business: To plan audit programme, it is necessary that the auditor should obtain from his client information as regards the client's history and business, purpose and nature of engagement and time schedule for the completion of audit.

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



3.2 Drawing up the Audit Programme

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

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practicable to draw up a typical audit programme. When an auditor is appointed to audit the accounts of an entity for the first time, the audit programme should be developed in three stages stated below:

(i) To begin with, a broad outline of the audit programme should be drawn up.

(ii) After the internal and accounting procedures have been reviewed, the details should be filled up on consideration of the deficiencies in the system of internal control.

(iii) After the detailed checking procedure is over, the extent to which the special procedures (first time/ opening balance audit procedures) that are required to be applied should be determined, e.g., independent verification of balances of debtors and creditors, physical inspection of fixed assets, personal inspection of various items of stock included in closing inventories and testing their values. At times, special procedures may have to be applied on a consideration of the nature of business e.g. verification of provision for tax liability in case of a shipping company regarding freight booked in different countries or for making a provision for unexpired liability in case of an insurance company, etc.

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

(i) experience gained during the previous audits;

(ii) important changes that have taken place in the business specially in the system of internal control, accounting procedures or in the structure of management or of the scope of business; and

(iii) evaluation of internal control made for the current year.

Given below are a few circumstances where in the audit programme would have to be suitably altered:	
(1)	If the audit procedures were designed for a certain volume of turnover and subsequently the volume have substantially increased. Also, when there have been significant changes in the accounting organisation, procedures and personnel subsequent to the audit procedures.
(2)	Where during the course of an audit, it has been discovered that internal control procedures were not as effective as assumed at the time the audit programme was framed.
(3)	Where there has been an extraordinary increase in the amount of book debts or that in the value of stocks as compared to that in the previous year.

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(4)	When a suspicion has aroused during the course of audit or information has been received that assets of the company have been misappropriated.
It may be noted that the audit plan and related programme should be reconsidered as the audit progresses. Such re-consideration is based on the auditor's review of internal control, his preliminary evaluation thereof and the result of his compliance and substantive procedures	

TEST YOUR UNDERSTANDING 2

CA Pradyuman is planning for audit of a listed company headquartered in Noida. While doing this exercise, he has made a list of various procedures intended to be performed by him during the course of audit. He has further made up his mind to decide about sample size at time of performing various planned procedures. Is the above approach of CA Pradyuman proper?

TEST YOUR UNDERSTANDING 3

CA Nikita is conducting audit of a leading society engaged in promoting awareness regarding usefulness of internet among the disadvantaged sections of society through easily understandable means and methods. The society is also registered under FCRA, 2010 for receipt of foreign contributions. During the course of audit, she embarked upon extensive procedures relating to verification of receipt of foreign contributions to rule out "round-tripping" in comparison to procedures originally thought of. She is documenting various procedures performed by her including relevant audit findings.

However, she doesn't not feel need for putting into writing about how she planned the whole exercise. Does she require refreshening of her knowledge?

4. AUDIT EXECUTION

Key phases in the audit execution stage are Execution Planning, Risk and Control Evaluation, Testing and Reporting.

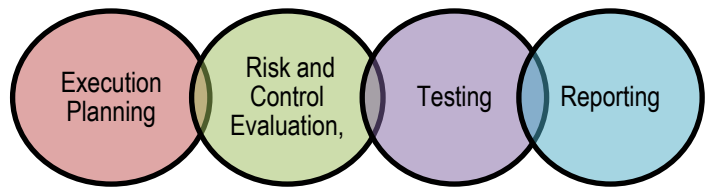


Image showing Stages of Audit Execution

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4.1 Execution Planning

Prior to commencement of an audit engagement, it is important to lay down the roadmap for audit execution to ensure timely and quality audit results. The auditors need to plan their work in order to carry out the audit in an effective, efficient and timely manner. A detailed audit program is prepared laying down the audit objectives, scope and audit approach. The manpower requirement, audit team qualifications, and the time element, etc. are some of the important considerations during execution planning. In order to plan effectively, the auditor may need some more information about the audit area. A preliminary survey would help in gathering the required information.

4.2 Risk and Control Evaluation

For each segment of audit, the auditors should conduct a detailed risk and control assessment i.e. list the risks that must be reviewed in that segment, capture for each risk the controls that exist or those that are needed to protect against the risk and show for each control, the work steps required to test the effectiveness of the controls. While making Risk & Control assessment, it is necessary to bear in mind the Materiality levels as the same is linked to Audit Risks.

(Note: Students may refer Chapter 4 for understanding and evaluation of the Risk and Control for more details)

4.3 Testing

Once a comprehensive understanding is gained of the key risks and the controls to be evaluated in a given audit area, the auditors should test the operating effectiveness of the controls to determine whether controls are operating as designed. There are multiple test methods which can be used to arrive at conclusions on the effectiveness of the controls.

4.4 Reporting

SA 700, "Forming an Opinion and Reporting on Financial Statements" establishes standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity. The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. This review and assessment involve considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements such as compliance of Provisions & Enactments of the Company Law, Accounting Standards framed by ICAI, latest Guidelines etc.

The auditor's report should contain a clear written expression of opinion on the financial statements

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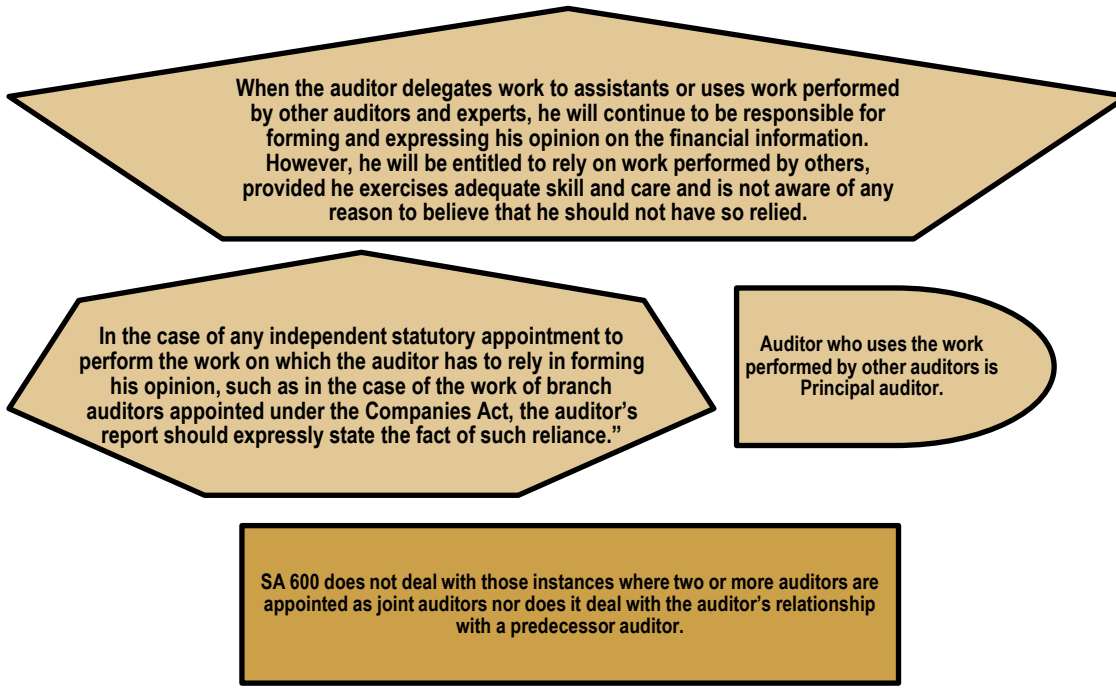
taken as a whole. A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur. A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report.

(Note: For details Students may refer SA 700 discussed in Chapter 7 of this study material)

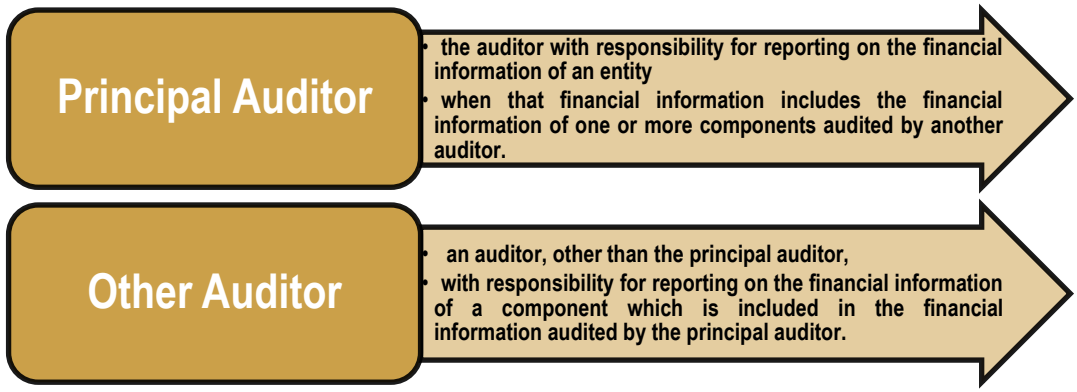
4.5 Other Important Considerations

In addition to above, there are certain other considerations which auditor is required to take care while executing the audit, that are given below:

4.5.1 SA 600 - Using the Work of Another Auditor



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"Component" means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.



The purpose of SA 600, "Using the Work of Another Auditor" is to:
establish standards to be applied in situations where Principal auditor,
uses the work of other auditor
with respect to the financial information of one or more components
included in the financial information of the entity.

This Standard also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor. In this Standard, the term 'financial information' encompasses 'financial statements'.

SA 600 does not deal with those instances where two or more auditors are appointed as joint auditors, nor does it deal with the auditor's relationship with a predecessor auditor.

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I. ACCEPTANCE AS PRINCIPAL AUDITOR

The auditor would consider the following before accepting his work as Principal auditor:

the materiality of the portion of the financial information which the principal auditor audits;	the principal auditor's degree of knowledge regarding the business of the components;	the risk of material misstatements in the financial information of the components audited by the other auditor(s); and	the performance of additional procedures as set out in this SA regarding the components audited by other auditor(s) resulting in the principal auditor having significant participation in such audit.

II. THE PRINCIPAL AUDITOR'S PROCEDURES

1. Right of Principal auditor to visit and examine books of accounts of a component



6. In certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would **normally be entitled to rely upon the work of such auditor** unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.

2. Principal auditor to consider the professional competence of other auditor

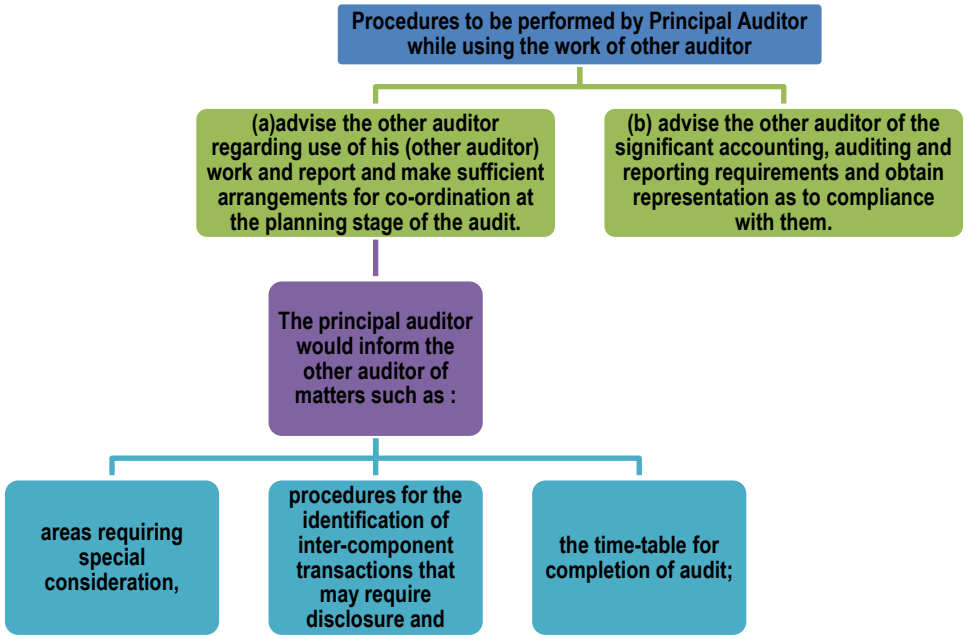


7. When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

3. Procedures to be performed by principal auditor when using the work of other auditor

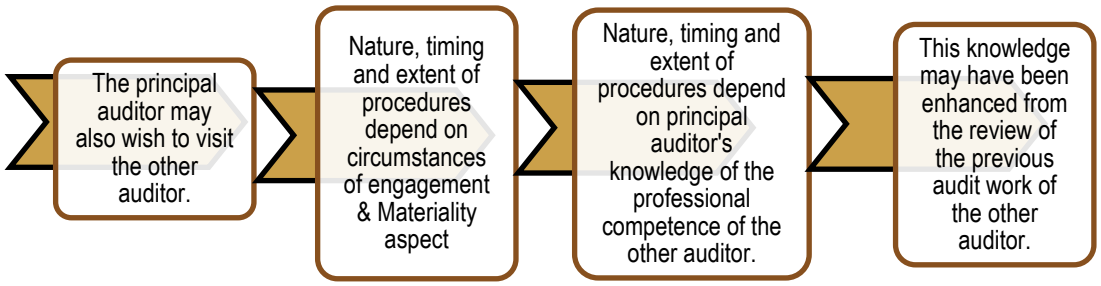
The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the procedures given in diagram below.

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4. Principal auditor to review – written summary of other auditor's procedures

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list.



5. The principal auditor should consider the significant findings of the other auditor.

The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components.

He may also decide as to application of supplementary procedures that supplement tests of the records or the financial statements of the component, if deemed necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

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6. When other auditor is not a professionally qualified auditor.

In certain circumstances, the other auditor may happen to be a person other than a professionally qualified auditor.



8. For instance, where a component is situated in a foreign country and the applicable laws permit a person other than a professionally qualified auditor to audit the financial statements of such component.

7. Principal Auditor to document in his working papers – the components whose financial information audited by other auditors. The principal auditor should also document the procedures performed and the conclusions reached.



9. The auditor would document the results of discussions with the other auditor and review of the written summary of the other auditor's procedures.

However, the principal auditor need not document the reasons for limiting the procedures in the circumstances where sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of other auditor's practice.

Where the other auditor's report is other than unmodified, the principal auditor should also document how he has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

III. CO-ORDINATION BETWEEN AUDITORS

There should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor-



10. By bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements.

Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

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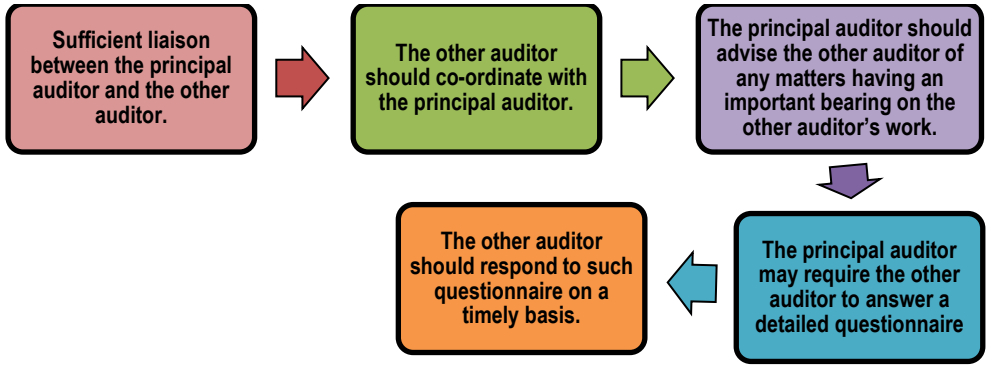


Diagram Showing Coordination Between the Auditors

IV. REPORTING CONSIDERATIONS

1. Principal auditor to express a qualified opinion or disclaimer of opinion in case of a limitation on the scope of audit.

11. When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

2. If the other auditor issues a Modified Report

12. In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor's report.

V. DIVISION OF RESPONSIBILITY

The principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors.

When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity. However, if the Principal Auditor notices any material

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discrepancies, the same has to be brought to the knowledge of other Auditor. This should be incorporated in the Audit Report.

TEST YOUR UNDERSTANDING 4

CA Sourabh, an engagement partner, is conducting statutory audit of BBI Bank for SBT & Associates. The bank has 1034 branches spread all over the country which are audited by branch auditors. In respect of one large branch audited by a branch auditor, there were errors in NPA classification of many advances which were not pointed out by branch auditor in his report through memorandum of changes and NIL memorandum of changes was reported electronically.

During overall review of financial statements of bank by statutory auditor, the above said errors did not come into light. The statutory auditor had also called soft copies of internal inspection report and concurrent audit reports of above branch as part of overall review procedures. However, these reports did not point towards any irregularities in such accounts.

Would the statutory auditor of bank be liable for above lapses? What precautions have to be taken by him while expressing opinion considering possibilities of such situations?

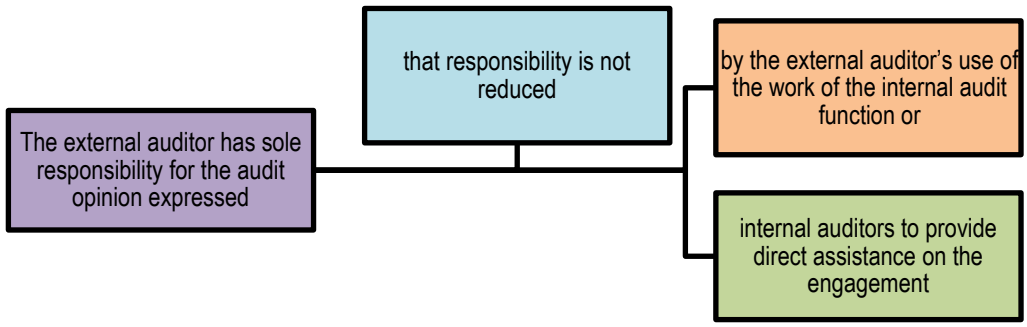
4.5.2 SA 610- Using the Work of Internal Auditors

I. THE EXTERNAL AUDITOR'S RESPONSIBILITY FOR THE AUDIT

The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement. Although they may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with SA 200.

SA 610, "Using the Work of Internal Auditors", therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.

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Review the Internal Auditor's Report which helps external auditor in procedural tests and audit planning.

II. SCOPE OF THIS SA

This (SA) deals with the external auditor's responsibilities if using the work of internal auditors. This includes	
(a)	using the work of the internal audit function in obtaining audit evidence and
(b)	using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

This SA does not apply if the entity does not have an internal audit function.

III. THE OBJECTIVES OF THE EXTERNAL AUDITOR, WHERE THE ENTITY HAS AN INTERNAL AUDIT FUNCTION

The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, or to use internal auditors to provide direct assistance, are:

The objectives of the external auditor, where the entity has an internal audit function		
To determine whether the work of the internal audit function or direct assistance from internal auditors can be used	If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit	If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

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Meaning of Internal Audit Function & Direct Assistance–
Internal Audit Function: A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.
Direct Assistance: The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

The objectives and scope of internal audit functions: The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

Activities Relating to Governance	*Activities Relating to Risk Management*	*Activities Relating to Internal Control*
The internal audit function may assess the governance process in its accomplishment of objectives on : • ethics and values, performance management and accountability, • communicating risk and control information.	• The internal audit function may assist the entity by identifying and evaluating significant exposures to risk. • The internal audit function may perform procedures to assist the entity in the detection of fraud.	• Evaluation of internal control • Examination of financial and operating information • Review of operating activities. • Review of compliance with laws and regulations.

IV. EVALUATING WHETHER WORK OF THE INTERNAL AUDIT FUNCTION CAN BE USED FOR PURPOSES OF THE AUDIT

(i) The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:	**(ii) The external auditor shall not use the work of the internal audit function if the external auditor determines that:**
(a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (b) The level of competence of the internal audit function; and (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.	(a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors; (b) The function lacks sufficient competence; or (c) The function does not apply a systematic and disciplined approach, including quality control.

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V. DETERMINING THE NATURE AND EXTENT OF WORK OF THE INTERNAL AUDIT FUNCTION THAT CAN BE USED

1. **The external auditor shall consider the nature and scope of the work performed by Internal audit function.**



13. Work of the internal audit function that can be used by the external auditor include the following:

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.
- Tracing transactions through the information system relevant to financial reporting.
- Testing of compliance with regulatory requirements.
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of SA 600.

2. **The external auditor shall make all significant judgments in the audit engagement** and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly:

(a)	More judgment is involved in: (i) Planning and performing relevant audit procedures; and (ii) Evaluating the audit evidence gathered;
(b)	The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant;
(c)	The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and
(d)	The lower the level of competence of the internal audit function.

3. Extent of involvement of external auditor: The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

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4. **Communicate how the external auditor has planned to use the work of the internal audit function:** The external auditor shall, in communicating with those charged with governance, share an overview of the planned scope and timing of the audit in accordance with SA 260, communicate how the external auditor has planned to use the work of the internal audit function.

VI. USING THE WORK OF THE INTERNAL AUDIT FUNCTION

1. **Discussion and Coordination with the Internal Audit Function:** If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities.

2. The external auditor shall **read the reports of the internal audit function** relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.

3. The external auditor **shall perform sufficient audit procedures to determine adequacy of internal audit function** for purposes of the audit, including evaluating whether:

   (a) The work of the function had been properly planned, performed, supervised, reviewed and documented;

   (b) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and

   (c) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed.

4. **The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:**

   (a) The amount of judgment involved;

   (b) The assessed risk of material misstatement;

   (c) The extent to which the internal audit function supports the objectivity of the internal auditors; and

   (d) The level of competence of the function.

5. The external auditor shall also evaluate **whether the external auditor's conclusions** regarding the internal audit function and the determination of the nature and extent of use of the work of the function for purposes of the audit **remain appropriate.**

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VII. DETERMINING WHETHER INTERNAL AUDITORS CAN BE USED TO PROVIDE DIRECT ASSISTANCE FOR PURPOSES OF THE AUDIT

(a) The external auditor prohibited from obtaining direct assistance from internal auditors.



14. In case where the external auditor is prohibited by law or regulation from using internal auditors to provide direct assistance, it is relevant for the principal auditors to consider whether the prohibition also extends to component auditors and, if so, to address this in the communication to the component auditors.

(b) Using internal auditors to provide direct assistance is not prohibited

(i) Evaluation of the existence and significance of threats to objectivity and the level of competence of the internal auditors.

(ii) Evaluation of the existence and significance of threats shall include inquiry of the internal auditors.

The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity **shall include inquiry of the internal auditors** regarding interests and relationships that may create a threat to their objectivity.

Objectivity refers to the ability to perform the proposed work without allowing bias, conflict of interest or undue influence of others to override professional judgments.

In evaluating the existence and significance of threats to the objectivity of an internal auditor, the following factors may be relevant:

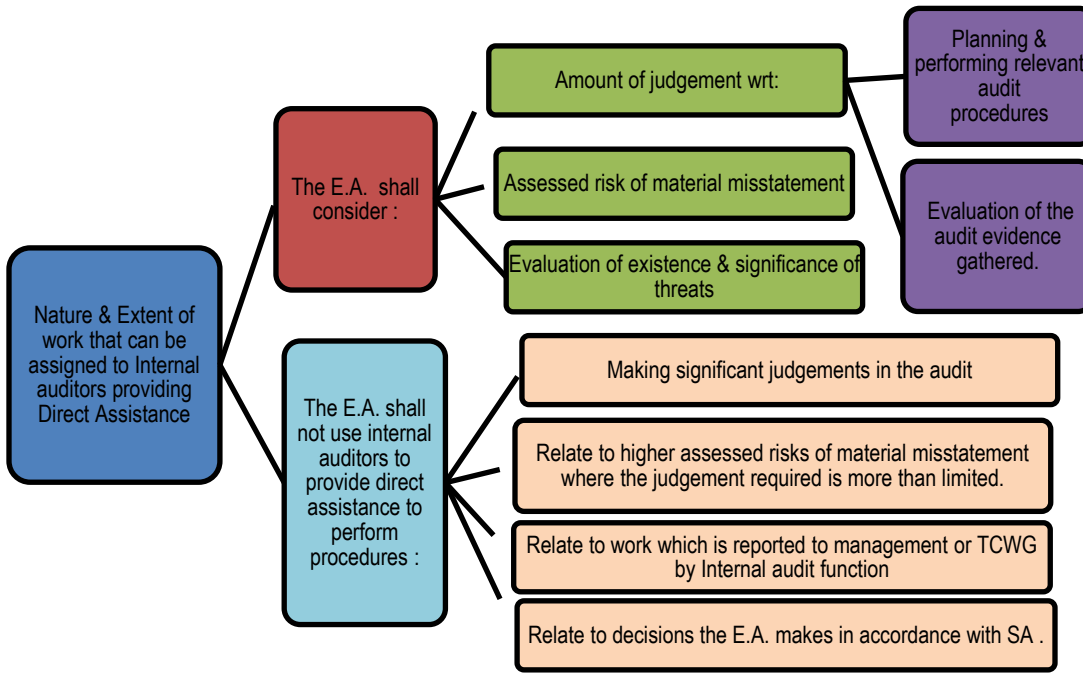
- The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors.
- Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates.
- Association with the division or department in the entity to which the work relates.
- Significant financial interests in the entity other than remuneration on terms consistent with those applicable to other employees at a similar level of seniority.

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The external auditor shall not use an internal auditor to provide direct assistance if:

(a) There are significant threats to the objectivity of the internal auditor; or	(b)The internal auditor lacks sufficient competence to perform the proposed work. As the function of Internal Auditor is again a concept of evaluation of Internal Control mechanism, it would amount to weaknesses in Internal Control System in case internal auditor does not apply required test procedures considering the Materiality aspects. This would in turn result in Higher Audit Risks.

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance:



Review of the work performed by Internal Auditors

The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with SA 220. In doing so:

(a) The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity; and

(b) The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.

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The direction, supervision and review by the external auditor shall be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

[**Note: Students are advised to refer SA 610 "Using the Work of Internal Auditor" for more details.**]

TEST YOUR UNDERSTANDING 5

CA Keshavraj is conducting statutory audit of a listed company "Live with Nature Limited". The company is engaged in producing environment-friendly niche products for new-born babies. There is also a well-functioning internal audit department in the company. On perusal of internal audit reports, he finds that not only verification of inventories was attended by internal auditor at regular intervals during the year, workings were also made in respect of inventory valuation as at year end.

He has also attended inventory count at end of financial year and no prima facie adverse inferences were drawn by him. However, ongoing through inventory reports, he gathers that inventories are being held for considerably long period before being sold. The internal audit reports have not taken this aspect into consideration. Should he choose to rely upon inventory valuation work performed by internal auditor?

Illustration 1

CA Amboj, a practicing chartered accountant, has been appointed as an internal auditor of Textile Ltd. He conducted the physical verification of the inventory at the year-end and handed over the report of such verification to CA Kishore, the statutory auditor of the Company, for his view and reporting. Can CA Kishore rely on such report?

Using the Work of Internal Auditor: As per SA 610 "Using the Work of Internal Auditors", while determining whether the work of the internal auditors can be used for the purpose of the audit, the external auditor shall evaluate-

(a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;

(b) The level of competence of the internal audit function; and

(c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.

Further, the external auditor shall not use the work of the internal audit function if the external auditor determines that:

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(a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

(b) The function lacks sufficient competence; or

(c) The function does not apply a systematic and disciplined approach, including quality control.

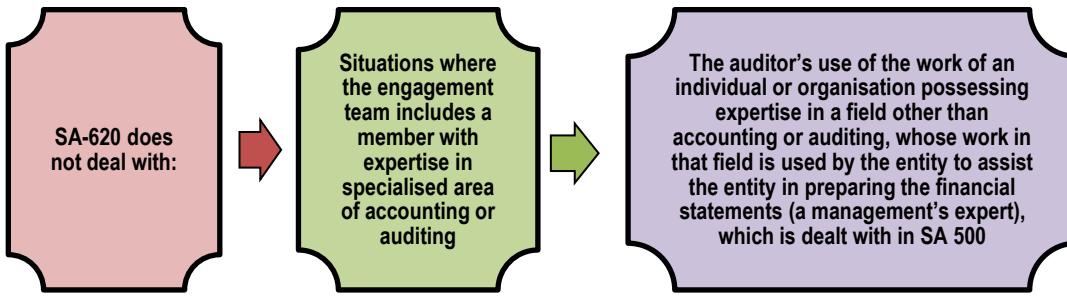
In the instant case, CA. Kishore should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible, he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The final responsibility to express opinion on the financial statement remains with the statutory auditor.

4.5.3 SA 620-Using the Work of an Auditor's Expert

I. SCOPE OF SA 620

SA 620 deals with the auditor's responsibilities regarding the use of work in a field of expertise other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.



Auditor's Expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

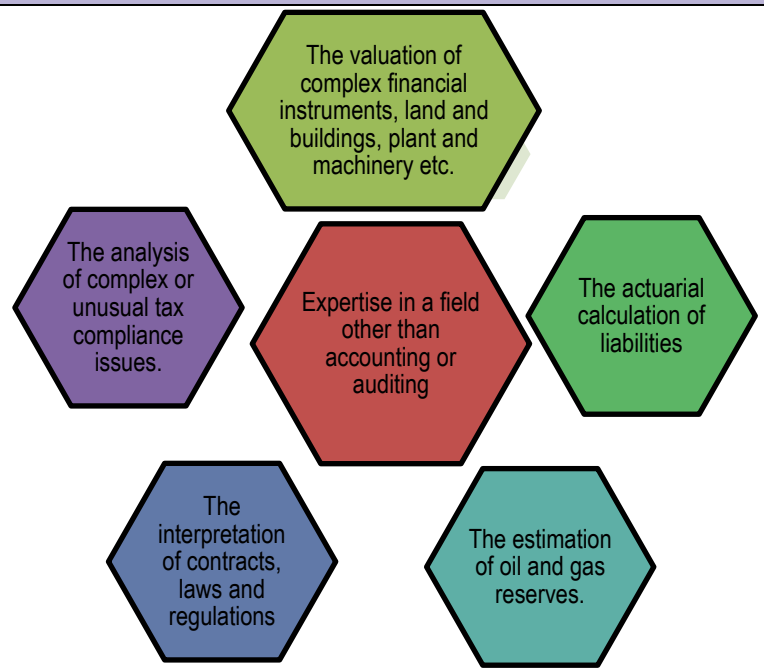
Management's Expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

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II. THE AUDITOR'S RESPONSIBILITY FOR THE AUDIT OPINION

The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert. Nonetheless, if the auditor using the work of an auditor's expert, having followed this SA, concludes that the work of that expert is adequate for the auditor's purposes, the auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence.

The objectives of the auditor are:	
(a)	To determine whether to use the work of an auditor's expert; and
(b)	If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.



III. DETERMINING THE NEED FOR AN AUDITOR'S EXPERT

An auditor's expert may be needed to assist the auditor in one or more of the following:

- Obtaining an understanding of the entity and its environment, including its internal control.
- Identifying and assessing the risks of material misstatement.
- Determining and implementing overall responses to assessed risks at the financial statement level.

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- Designing and performing further audit procedures to respond to assessed risks at the assertion level, comprising tests of controls or substantive procedures.
- Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements.

Auditor may obtain understanding of other field: An auditor who is not an expert in a relevant field other than accounting or auditing may nevertheless be able to obtain a sufficient understanding of that field to perform the audit without an auditor's expert. This understanding may be obtained through.



15. Experience in auditing entities that require such expertise in the preparation of their financial statements.

- Education or professional development in the particular field. This may include formal courses, or discussion with individuals possessing expertise in the relevant field for the purpose of enhancing the auditor's own capacity to deal with matters in that field. Such discussion differs from consultation with an auditor's expert regarding a specific set of circumstances encountered on the engagement where that expert is given all the relevant facts that will enable the expert to provide informed advice about the particular matter.
- Discussion with auditors who have performed similar engagements.

IV. CONSIDERATIONS WHEN DECIDING WHETHER TO USE AN AUDITOR'S EXPERT

In other cases, however, the auditor may determine that it is necessary, or may choose, to use an auditor's expert to assist in obtaining sufficient appropriate audit evidence.

Considerations when deciding whether to use an auditor's expert may include:

- Whether management has used a management's expert in preparing the financial statements.
- The nature and significance of the matter, including its complexity.
- The risks of material misstatement in the matter.
- The expected nature of procedures to respond to identified risks, including the auditor's knowledge of and experience with the work of experts in relation to such matters; and the availability of alternative sources of audit evidence.

When management has used a management's expert

When management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

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- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- The management's expert's competence and capabilities.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- Any controls within the entity over the management's expert's work.

V. NATURE, TIMING AND EXTENT OF AUDIT PROCEDURES

The nature, timing and extent of the auditor's procedures will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including:

(a) The nature of the matter to which that expert's work relates;

(b) The risks of material misstatement in the matter to which that expert's work relates;

(c) The significance of that expert's work in the context of the audit;

(d) The auditor's knowledge of and experience with previous work performed by that expert; and

(e) Whether that expert is subject to the auditor's firm's quality control policies and procedures.



16. The following factors may suggest the need for different or more extensive procedures than would otherwise be the case:

- The work of the auditor's expert relates to a significant matter that involves subjective and complex judgments.
- The auditor has not previously used the work of the auditor's expert, and has no prior knowledge of that expert's competence, capabilities and objectivity.
- The auditor's expert is performing procedures that are integral to the audit, rather than being consulted to provide advice on an individual matter.
- The expert is an auditor's external expert and is not, therefore, subject to the firm's quality control policies and procedures.

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VI. THE COMPETENCE, CAPABILITIES AND OBJECTIVITY OF THE AUDITOR'S EXPERT

The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.



17. In case where that expert's work is subject to technical performance standards or other professional or industry requirements, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

VII. OTHER MATTERS THAT MAY BE RELEVANT INCLUDE

- The relevance of the auditor's expert's competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field.



18. A particular actuary may specialise in property and casualty insurance, but has limited expertise regarding pension calculations.

- The auditor's expert's competence with respect to relevant accounting and auditing requirements



19. Knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.

- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the auditor's expert as the audit progresses.

VIII. EVALUATION OF THE SIGNIFICANCE OF THREATS TO OBJECTIVITY AND NEED FOR SAFEGUARDS

The evaluation of the significance of threats to objectivity and of whether there is a need for safeguards may depend upon the role of the auditor's expert and the significance of the expert's work in the context of the audit.



20. If a proposed auditor's expert is an individual who has played a significant role in preparing the information that is being audited, that is, if the auditor's expert is a management's expert.

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Evaluating the objectivity of an auditor's external expert: When evaluating the objectivity of an auditor's external expert, it may be relevant to:

(a) **Inquire of the entity** about any known interests or relationships that the entity has with the auditor's external expert that may affect that expert's objectivity.

(b) **Discuss with that expert** any applicable safeguards, including any professional requirements that apply to that expert; and evaluate whether the safeguards are adequate to reduce threats to an acceptable level. Interests and relationships that may be relevant to discuss with the auditor's expert include:

- Financial interests.
- Business and personal relationships.
- Provision of other services by the expert
- In some cases, it may also be appropriate for the auditor to obtain a written representation from the auditor's external expert about any interests or relationships with the entity of which that expert is aware.

IX. OBTAINING AN UNDERSTANDING OF THE FIELD OF EXPERTISE OF THE AUDITOR'S EXPERT

The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to:

(a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and

(b) Evaluate the adequacy of that work for the auditor's purposes.

X. AGREEMENT WITH THE AUDITOR'S EXPERT

The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert:

(a) The nature, scope and objectives of that expert's work;

(b) The respective roles and responsibilities of the auditor and that expert;

(c) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and

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When the work of the auditor's expert relates to the auditor's conclusions regarding a significant risk, both a formal written report at the conclusion of that expert's work, and oral reports as the work progresses, may be appropriate. Identification of specific partners or staff who will liaise with the auditor's expert, and procedures for communication between that expert and the entity, assists timely and effective communication, particularly on larger engagements.

(d) The need for the auditor's expert to observe confidentiality requirements.

It is necessary for the confidentiality provisions of relevant ethical requirements that apply to the auditor also to apply to the auditor's expert. Additional requirements may be imposed by law or regulation. The entity may also have requested that specific confidentiality provisions be agreed with auditor's external experts.

XI. EVALUATING THE ADEQUACY OF THE AUDITOR'S EXPERT'S WORK

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

(a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence.

The Findings and Conclusions of the Auditor's Expert

Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:

- Inquiries of the auditor's expert.
- Reviewing the auditor's expert's working papers and reports.
- Corroborative procedures, such as:
  - Observing the auditor's expert's work;
  - Examining published data, such as statistical reports from reputable, authoritative sources;
  - Confirming relevant matters with third parties;
  - Performing detailed analytical procedures to see whether Principles of materiality aspects considered; and
  - Re-performing calculations.
- Discussion with another expert with relevant expertise when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.
- Discussing the auditor's expert's report with management.

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(b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and

Assumptions and Methods: When the auditor's expert's work is to evaluate underlying assumptions and methods, including models where applicable, used by management in developing an accounting estimate, the auditor's procedures are likely to be primarily directed to evaluating whether the auditor's expert has adequately reviewed those assumptions and methods.

When the auditor's expert's work is to develop an auditor's point estimate or an auditor's range for comparison with management point's estimate, the auditor's procedures may be primarily directed to evaluating the assumptions and methods, including models where appropriate, used by the auditor's expert.

SA 540 discusses the assumptions and methods used by management in making accounting estimates, including the use in some cases of highly specialised, entity-developed models. Although that discussion is written in the context of the auditor obtaining sufficient appropriate audit evidence regarding management's assumptions and methods, it may also assist the auditor when evaluating an auditor's expert's assumptions and methods.

When an auditor's expert's work involves the use of significant assumptions and methods, factors relevant to the auditor's evaluation of those assumptions and methods include whether they are:

- Generally accepted within the auditor's expert's field;
- Consistent with the requirements of the applicable financial reporting framework;
- Dependent on the use of specialised models; and

Consistent with those of management, and if not, the reason for, and effects of, the differences.

(c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

When an auditor's expert's work involves the use of source data that is significant to that expert's work, procedures such as the following may be used to test that data:

- Verifying the origin of the data, including obtaining an understanding of, and where applicable testing, the internal controls over the data and, where relevant, its transmission to the expert.
- Reviewing the data for completeness and internal consistency

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XII. WHEN WORK OF THE AUDITOR'S EXPERT IS NOT ADEQUATE FOR THE AUDITOR'S PURPOSES

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

(a) Agree with that expert on the nature and extent of further work to be performed by that expert; or

(b) Perform further audit procedures appropriate to the circumstances.



21. Inadequate Work : If the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with SA 705 because the auditor has not obtained sufficient appropriate audit evidence.

XIII. REFERENCE TO THE AUDITOR'S EXPERT IN THE AUDITOR'S REPORT

1 The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion.



22. In some cases, law or regulation may require a reference to the work of an auditor's expert, for the purposes of transparency in the public sector.

2 If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion.

ILLUSTRATION 2

While doing audit, Ram, the Auditor requires reports from experts for the purpose of Audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same?

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Using the Work of an Auditor's Expert: As per SA 620, "Using the Work of an Auditor's Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.

While doing audit, Ram, the auditor can obtain the following types of reports, or options or statements of an expert for the purpose of audit evidence:

(i) The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.

(ii) The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.

(iii) The estimation of oil and gas reserves.

(iv) The valuation of environmental liabilities, and site clean-up costs.

(v) The interpretation of contracts, laws and regulations.

(vi) The analysis of complex or unusual tax compliance issues.

When the auditor intends to use the work of an expert, he shall evaluate the adequacy of the auditor's expert's work, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; if that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and if that expert's work involves the use of source data that is significant to his work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, he shall agree with that expert on the nature and extent of further work to be performed by that expert; or perform further audit procedures appropriate to the circumstances.

4.5.4 SA 540-Auditing Accounting Estimates, Including Fair Value Accounting Estimates & Related Disclosures

I. SCOPE OF THIS SA

This Standard on Auditing (SA) deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 and other relevant SAs are to be

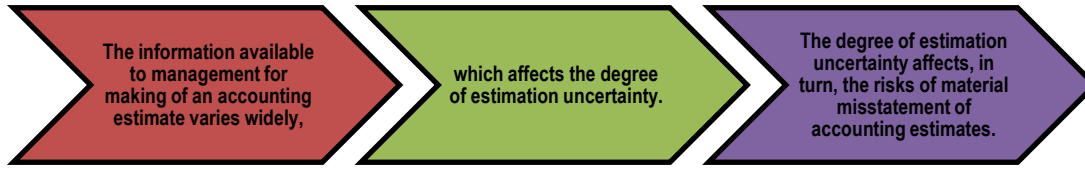
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applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.



II. NATURE OF ACCOUNTING ESTIMATES

Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates.



Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item.



23. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements,

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.
- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as "observable" in the context of a fair value accounting estimate.
- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.

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- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.



24. For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which, there are assumptions or inputs that cannot be observed in the marketplace. Accounting estimates in cases of Wage Revision Agreements wherein negotiations with the Trade Unions is on the way or Government's sanction is awaited leading to uncertainty.

III. THE DEGREE OF ESTIMATION UNCERTAINTY

The degree of estimation uncertainty varies based on :		
the nature of the accounting estimate,	the extent to which there is a generally accepted method used to make the accounting estimate,	the subjectivity of the assumptions used to make the accounting estimate

1. Not all financial statement items requiring measurement at fair value, involve estimation uncertainty.



25. This may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value.

However, estimation uncertainty may exist even when the valuation method and data are well defined. **For example,** valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

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26. Examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long-term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.



27. Examples of situations where fair value accounting estimates may be required include:

- Complex financial instruments, which are not traded in an active and open market.
- Share-based payments.
- Property or equipment held for disposal.
- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

2. **Estimation involves judgments**: Estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

IV. MANAGEMENT BIAS

Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias **(for example, as a result of motivation to achieve a desired result).**

The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it.

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Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

Management bias can be difficult to detect at an account level.

- It may only be identified when considered in the aggregate of groups of accounting estimates or
- all accounting estimates, or
- when observed over a number of accounting periods.

Although some form of management bias is inherent in subjective decisions, in making such judgments, there may be no intention by management to mislead the users of financial statements.

Where, however, there is intention to mislead, management bias is fraudulent in nature.

V. THE MEASUREMENT OBJECTIVE OF ACCOUNTING ESTIMATES

The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability.



28. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as "marketplace participants" or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.

A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

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VI. OBJECTIVE OF SA 540

The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:

(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and

(b) related disclosures in the financial statements are adequate.

Important Definition:
Accounting estimate – An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this SA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used. **Auditor's point estimate or auditor's range** – The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate
Management bias – A lack of neutrality by management in the preparation and presentation of information. **Management's point estimate** – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
Estimation uncertainty – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement. **Outcome of an accounting estimate** –The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

VII. AUDITOR'S RESPONSIBILITY /AUDIT PROCEDURES

1. **Risk assessment procedures and related activities for accounting estimates:** When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by SA 315, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

   (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.

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(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. As the assessment of accounting estimates affects the ultimate decision in forming an opinion, much care has to be taken in this regard. It is highly important as the auditor's conclusion is based on above basis.

2. **Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates:** In preparing the financial statements, management has the responsibility to determine whether a transaction, event or condition gives rise to the need to make an accounting estimate, and that all necessary accounting estimates have been recognised, measured and disclosed in the financial statements in accordance with the applicable financial reporting framework.

The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for an accounting estimate.

Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates that have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. SA 315 deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment processes.

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3. **How management makes the accounting estimates:** How management makes the accounting estimates, and an understanding of the data on which they are based, including:

   (i) The method, including where applicable the model, used in making the accounting estimate;

   (ii) Relevant controls;

   (iii) Whether management has used an expert;

   (iv) The assumptions underlying the accounting estimates;

   (v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and

   (vi) Whether and, if so, how management has assessed the effect of estimation uncertainty.

   The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.

4. **Estimation Uncertainty:** For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330, the auditor shall evaluate the following:

   (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

   (b) Whether the significant assumptions used by management are reasonable.

   (c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

   If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the

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auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate.

Recognition and Measurement Criteria: For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence whether the following are in accordance with the requirements of the applicable financial reporting framework:

(a) management's decision to recognise, or to not recognise, the accounting estimates in the financial statements; and

(b) the selected measurement basis for the accounting estimates.

I. Identifying and Assessing the Risks of Material Misstatements:

(a) In identifying and assessing the risks of material misstatement as required by SA 315, the auditor shall evaluate the degree of estimation uncertainty associated with accounting estimates.

(b) The auditor shall determine whether, in the auditor's judgment, any of those accounting estimate that have been identified as having high estimation uncertainty give rise to significant risk.

II. Responses to the Assessed Risks of Material Misstatement:

(a) Based on assessed risk of material misstatement the auditor, shall determine:

- Whether management has appropriately applied the applicable financial reporting framework relevant to the accounting estimate; and.
- Whether the methods for making the accounting estimates are appropriate and have been applied consistently
- If there are changes in accounting estimates or in the method used for making those from prior period, are those appropriate in the present circumstances.

(b) In response to the assessed risk of material misstatement, the auditor shall undertake one or more of the following, taking in account the nature of the accounting estimates.

- Determine whether events occurring up to the date of the auditor's report provide sufficient audit evidence regarding the accounting estimate.

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- Test checks the data used by the management for making accounting estimate.
- The auditor shall also evaluate whether the method used for measurement is appropriate in the circumstances and assumptions made by the management are reasonable in the light of the measurement objective of the applicable financial reporting. This can be achieved by
- Testing the extent to which data on which accounting estimate is based is accurate, complete and relevant and whether the accounting estimate has been properly determined using such data and management assumptions.
- Considering the source, relevance and reliability of external data.
- Recalculating the accounting estimate and reviewing information about an accounting estimate for internal consistency.
- Test checks the effectiveness of the controls over the estimates used by the management together with appropriate substantive procedure.

(c) While determining the matters identified or in responding to the assessed risks of material misstatement, the auditor shall consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence.

5. Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements: The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated.

VIII. AUDIT REPORTING & DISCLOSURE

Disclosures Related to Accounting Estimates

The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.

For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework

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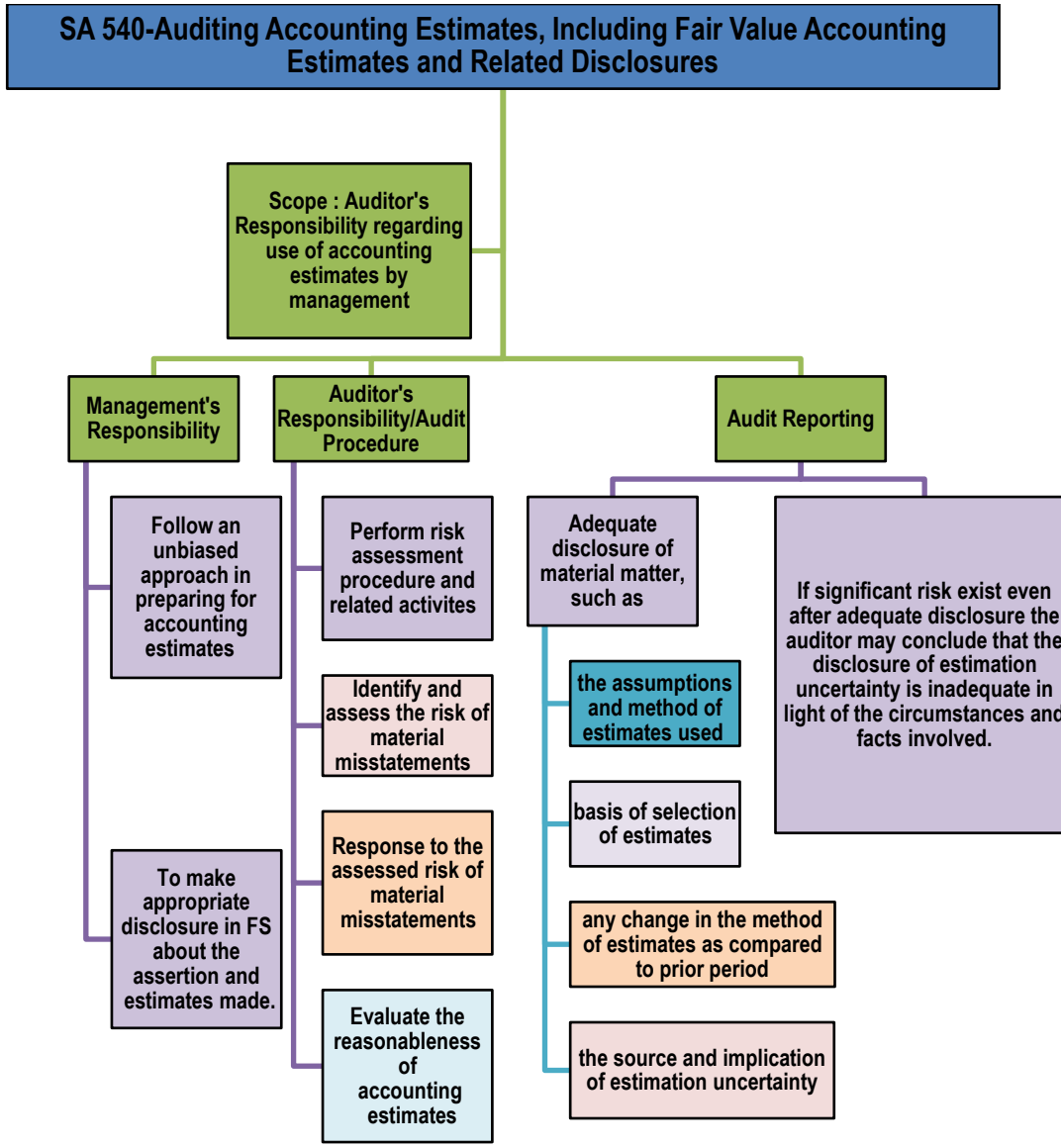
(a) The presentation of financial statement in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. These disclosures may include, • The assumptions used. • The method of estimation used, including any applicable model. • The basis for the selection of the estimation. • Any changes in the method of estimation from prior period and its subsequent effect. • The sources and implication of estimation uncertainty.	**(b)** In relation to accounting estimate having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved.

Written Representations: The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

Documentation of Accounting Estimates

The audit documentation shall include:	
(a)	The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
(b)	Indicators of possible management bias, if any.

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4.5.5 Control of Quality of Audit Work

Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

(a) The firm and its personnel comply with professional standards and regulatory and legal requirements; and

(b) The reports issued by the firm or engagement partners are appropriate in the circumstances.

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Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise. SA 220 deals with audit quality at individual engagement level.

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.

(Students may refer Chapter 1 Quality Control for more details)

4.5.6 Analytical Procedures Prior to Audit as well as Towards Finalization

I. WHEN DESIGNING AND PERFORMING SUBSTANTIVE ANALYTICAL PROCEDURES

As per SA 520, "Analytical Procedures" the auditor shall:

(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required.

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II. ANALYTICAL PROCEDURES THAT ASSIST WHEN FORMING AN OVERALL CONCLUSION

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

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

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

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

III. INVESTIGATING RESULTS OF ANALYTICAL PROCEDURES

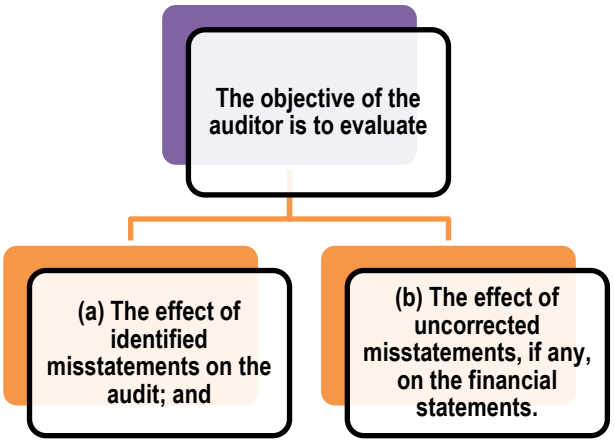
If analytical procedures performed in accordance with this SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
(b) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

4.5.7 SA 450 - Evaluation of Misstatements Identified During the Audit

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

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Important Definition:

Misstatement – A difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

4.5.7.1 Accumulation of Identified Misstatements

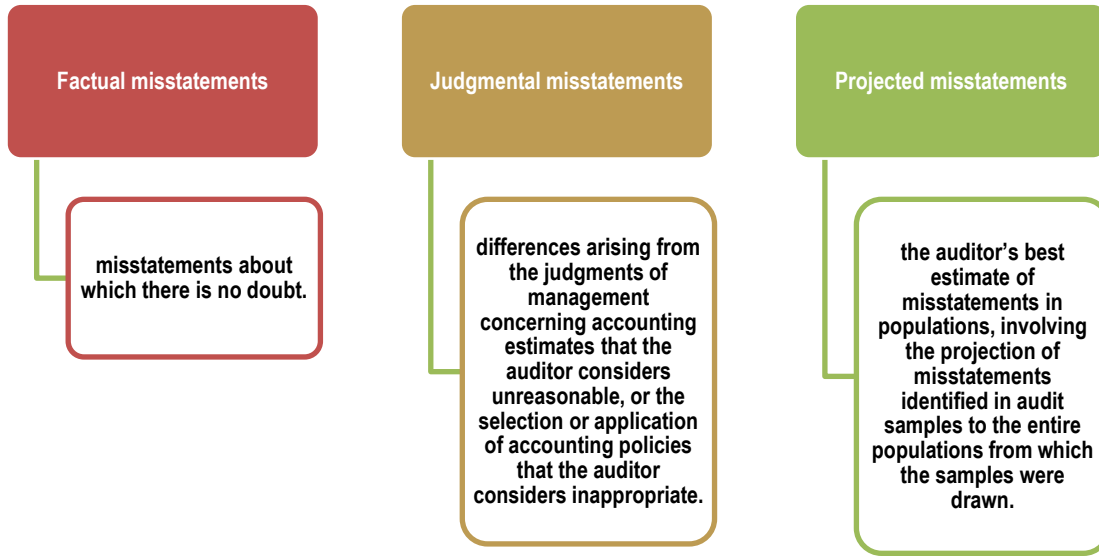
The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements.

"Clearly trivial" is not another expression for "not material". Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with SA 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances.

When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

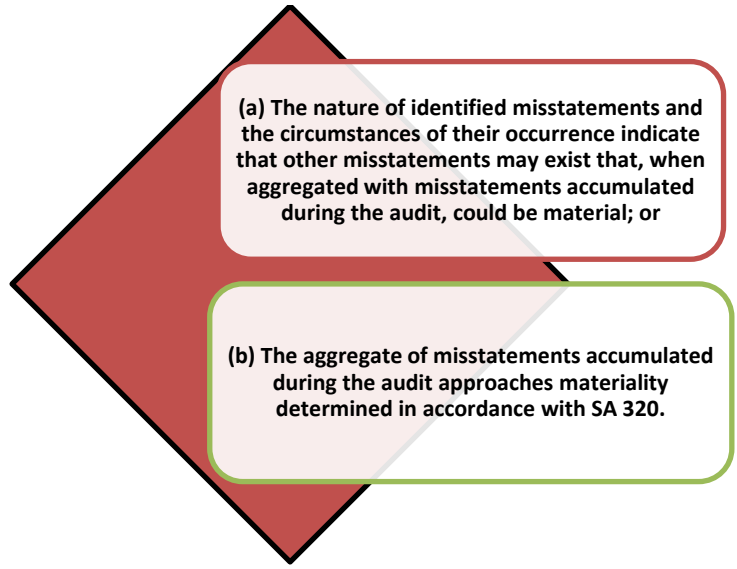
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To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.



4.5.7.2 Consideration of Identified Misstatements as the Audit Progresses

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



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

4.5.7.3 Communication and Correction of Misstatements

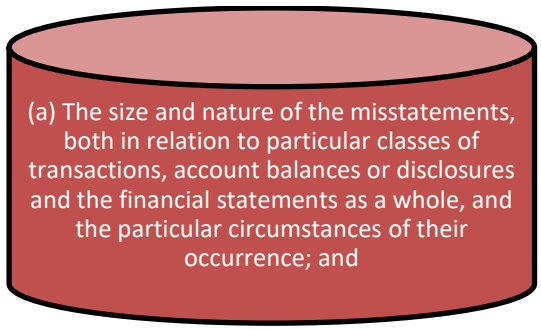
The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation.The auditor shall request management to correct those misstatements.

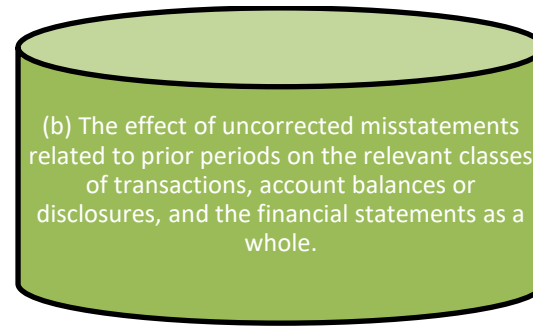
If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are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

4.5.7.4 Evaluating the Effect of Uncorrected Misstatements

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

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





4.5.7.5 Communication with Those Charged with Governance

The auditor shall communicate with those charged with governance, in accordance with SA 260, uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.

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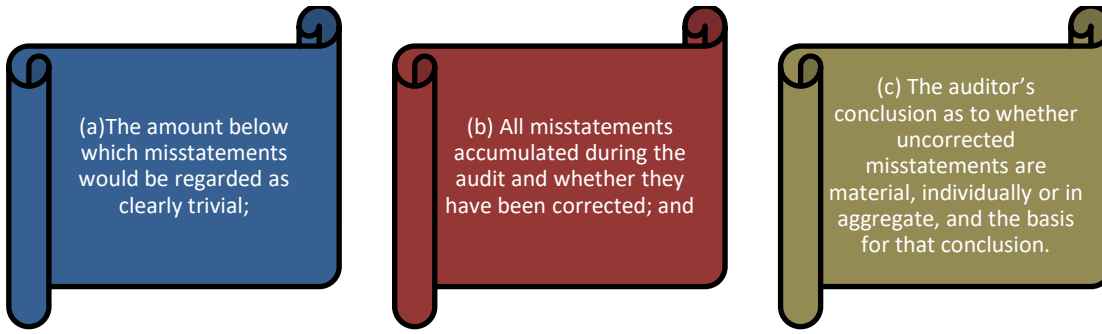
The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

4.5.7.6 Written Representation

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

4.5.7.7 Documentation

The audit documentation shall include:



Key Takeaways

- Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan.
- The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
- The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members.
- The audit programme may contain audit objectives for each area and should have sufficient detail to serve as a set of instructions to the assistants involved in the audit and as means to control the proper execution of work.
- During audit execution, there are certain other considerations which auditor is required to take care of while executing the audit including responsibilities to use work of other auditor, work of internal auditors, work of auditor's expert. Besides, the auditor has responsibilities regarding estimates. He has to apply analytical procedures towards finalization of audit in

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accordance with SA 520. Engagement has to be performed in qualitative manner in accordance with SA 220.

- SA 600 discusses the principal auditor's responsibility in relation to his use of the work of the other auditor.
- SA 610 defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit.
- SA 620 deals with the auditor's responsibilities regarding the use of work in a field of expertise other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence
- SA 540 deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM: SCAN ME !

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?*

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2. *KRP Ltd., at its annual general meeting, appointed Mr. X, Mr. Y and Mr. Z as joint auditors to conduct audit for the financial year 2023-24. For the valuation of gratuity scheme of the company, Mr. X, Mr. Y and Mr. Z wanted to refer their own known Actuaries. Due to difference of opinion, all the joint auditors consulted their respective Actuaries. Subsequently, major difference was found in the actuarial reports. However, Mr. X agreed to Mr. Y's actuary report, though Mr. Z did not. Mr. X contends that Mr. Y's actuary report shall be considered in audit report due to majority of votes. Now, Mr. Z is in a dilemma. Explain the responsibility of auditors, in case, report made by Mr. Y's actuary, later, was found faulty.*

3. *A & Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan?*

4. *As an auditor of a garment manufacturing company for the last five years, you have observed that new venture of online shopping has been added by the company during current year. What factors would be considered by you in formulating the audit strategy of the company?*

5. *During the audit of FMP Ltd, a listed company, Engagement Partner (EP) completed his reviews and also ensured compliance with independence requirements that apply to the audit engagement. The engagement files were also reviewed by the Engagement Quality Control Reviewer (EQCR) except the independence assessment documentation. Engagement Partner was of the view that matters related to independence assessment are the responsibility of the Engagement Partner and not Engagement Quality Control Reviewer. Engagement Quality Control Reviewer objected to this and refused to sign off the documentation. Please advise as per SA 220.*

6. *AKJ Ltd is a small-sized 30 years old company having business of manufacturing of pipes. Company has a plant based out of Dehradun and have their corporate office in Delhi. Recently the company appointed new firm of Chartered Accountants as their statutory auditors.*

   The statutory auditors want to enter into an engagement letter with the company in respect of their services but the management has contended that since the statutory audit is mandated by law, engagement letter may not be required. Auditors did not agree to this and have shared a format of engagement letter with the management for their reference before getting that signed. In this respect management would like to understand that as per SA 210 (auditing standard referred to by the auditors), if the agreed terms of the engagement shall be recorded in an engagement letter or other suitable form of written agreement, what should be included in terms of agreed audit engagement letter?

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7. *A private company is engaged in the business of real estate. The auditor of the company requested the information from the management to review the outcome of accounting estimates (like estimated costs considered for percentage completion etc) included in the prior period financial statements and their subsequent re-estimation for the purpose of the current period.*

   The management has refused the information to the auditor saying that the review of prior period information should not be done by the auditor. Please advise.

8. *X Ltd had a net worth of INR 1300 crores because of which Ind AS became applicable to them. The company had various derivative contracts – options, forward contracts, interest rate swaps etc. which were required to be fair valued for which company got the fair valuation done through an external third party. The statutory auditors of the company involved an auditor's expert to audit valuation of derivatives. The auditor and auditor's expert were new to each other i.e. they were working for the first time together but developed a good bonding during the course of the audit. The auditor did not enter into any formal agreement with the auditor's expert. Please advise.*

9. *Cineplex, a movie theatre complex, is the foremost theatre located in Delhi. Along with the sale of tickets over the counter and online booking, the major proportion of income is from the cafe, shops, pubs etc. located in the complex. Its other income includes advertisements exhibited within/outside the premises such as hoardings, banners, slides, short films etc. The facility for parking of vehicles is also provided in the basement of the premises.*

   Cineplex appointed your firm as the auditor of the entity. Being the head of the audit team, you are, therefore, required to draw an audit programme initially in respect of its revenue and expenditure considering the above mentioned facts along with other relevant points relating to such complex.

Answers to Test your Understanding

1. SA 300 requires the auditor to plan the audit in such a manner that it is performed effectively. It also requires auditor to establish overall audit strategy including identifying the characteristics of the engagement, facilitating him to define its scope and planning of nature, timing and extent of audit procedures required to be performed to achieve the objective of audit.

SA 300 further requires the auditor to document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to such plans.

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In the given situation, auditor didn't even once visit the company and failed to understand about business of the company. Therefore, he has flouted requirement of SA 300 to plan the audit in such a manner that it is performed effectively. The auditor has to plan the audit commensurate to the nature and complexity of the business of the entity and identify and assess the risk of material misstatement.

Further, working papers of auditor also do not show his understanding of nature of business which is again a blatant violation of requirement of SA 300 which requires the auditor to document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to such plans.

Inclusion of a checklist in working papers having requirement of test checking of cost of raw material consumed & cost of stores and spares shows that it was a general checklist and specifics of business were never understood and audit was not planned to be conducted in an effective manner in accordance with requirements of SA 300.

2. SA 300 states that audit plan shall include description about nature, timing and extent of audit procedures. The extent of audit procedures also includes deciding about sample sizes to be tested for performing audit procedures. Therefore, the said approach is not proper. Various procedures planned to be undertaken should also include considerations relating to sample sizes to be tested.

3. SA 300 requires auditor to document audit plan and significant changes made during the audit engagement to the audit plan. It also requires auditor to document reasons for such changes.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

Further, changes to audit plan along with reasons thereof due to embarking upon extensive procedures related to verification of foreign contributions in comparison to what was originally envisaged need to be documented.

Failure to document audit plan could entail risk of not conducting audit according to professional standards in a qualitative manner.

4. SA 600 states that the principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors. When the principal

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auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.

In the given situation, nothing has come to light of statutory auditor which would arouse his suspicion about reliability of work performed by branch auditor. Therefore, he would not be responsible for work performed by branch auditor.

Further, it should be clearly stated in the report that 1034 branches of bank have been audited by branch auditors.

5. For a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly and accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in SA 200, the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly.

In the given situation, inventories are being held for considerably long period before being sold. As company is dealing in niche products for new-born babies, there is a risk of inventory obsolescence due to changes in customer preferences. It carries a significant risk of material misstatement and requires more judgment on part of statutory auditor in planning and performing procedures.

In such circumstances, statutory auditor needs to perform procedures directly like comparing net realizable value of products with costs to verify completeness of provisions, recomputing of provisions for obsolete stocks etc.

Therefore, in the given situation, he should perform procedures directly in accordance with SA 610.

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Answers to Theoretical Questions

1. As per **SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"**, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates:

(i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.

(ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

(iii) The estimation making process adopted by the management including-

(1) The method, including where applicable the model, used in making the accounting estimates.

(2) Relevant controls.

(3) Whether management has used an expert?

(4) The assumption underlying the accounting estimates.

(5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and

(6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.

2. **Using the work of an Auditor's Expert:** As per SA 620 "Using the Work of an Auditor's Expert", the expertise of an expert may be required in the actuarial calculation of liabilities associated with insurance contracts or employee benefit plans etc., however, the auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence as per SA 500.

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Further, in view of SA 620, if the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods must be ensured by the auditor and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be verified by the auditor.

In the instant case, Mr. X, Mr. Y and Mr. Z, jointly appointed as auditors of KRP Ltd., referred their own known Actuaries for valuation of gratuity scheme. Actuaries are an auditor's expert as per SA 620. Mr. Y's referred actuary has provided the gratuity valuation report, which later on was found faulty. Further, Mr. Z is not in agreement with this report, therefore, he submitted a separate audit report specifically for such gratuity valuation.

In such situation, it was duty of Mr. X, Mr. Y and Mr. Z, before using the gratuity valuation report of Actuary, to ensure the relevance and reasonableness of assumptions and methods used. They were also required to examine the relevance, completeness and accuracy of source data used for such report before expressing their opinion.

Mr. X and Mr. Y will be held responsible for gross negligence and using such faulty report without examining the adequacy of expert actuary's work whereas Mr. Z will not be held liable for the same due to separate opinion expressed by him.

3. **Development of an overall plan** - Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

   (i) Terms of his engagement and any statutory responsibilities.

   (ii) Nature and timing of reports or other communications.

   (iii) Applicable Legal or Statutory requirements.

   (iv) Accounting policies adopted by the clients and changes, if any, in those policies.

   (v) The effects of new accounting and auditing pronouncement on the audit.

   (vi) Identification of significant audit areas.

   (vii) Setting of materiality levels for the audit purpose.

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(viii) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.

(ix) Degree of reliance to be placed on the accounting system and internal control.

(x) Possible rotation of emphasis on specific audit areas.

(xi) Nature and extent of audit evidence to be obtained.

(xii) Work of the internal auditors and the extent of reliance on their work, if any in the audit.

(xiii) Involvement of other auditors in the audit of subsidiaries or branches of the client and involvement of experts.

(xiv) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.

(xv) Establishing and coordinating staffing requirements.

4. **Formulation of Audit Strategy:** While formulating the audit strategy for a company, following factors may be considered -

General Factors: Refer Para 2.1.

Specific Factors for Online Shopping:

The auditor shall also obtain an understanding of the information system including the related business processes due to new venture of online shopping in the following areas:

(i) The classes of transactions in the entity's operations that are significant to the financial statements;

(ii) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(iii) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;

(iv) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;

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(v) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

5. As per SA 220, Engagement Partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, Engagement Partner shall:

- Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Engagement Partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

As per SA 220, "Quality Control for Audit of Financial Statements", for audits of financial statements of listed entities, Engagement Quality Control Reviewer (EQCR), on performing an engagement quality control review, shall also consider the engagement team's evaluation of the firm's independence in relation to the audit engagement.

In the given case, Engagement Partner is not right. The independence assessment documentation should also be given to Engagement Quality Control Reviewer for his review.

6. As per SA 210 'Agreeing the Terms of Audit Engagements', 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 and shall include:

(i) The objective and scope of the audit of the financial statements;

(ii) The responsibilities of the auditor;

(iii) The responsibilities of management;

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(iv) Identification of the applicable financial reporting framework for the preparation of the financial statements; and

(v) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

7. As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.

The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.

In the given case, the management is not correct in refusing the relevant information to the auditor.

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8. As per SA 620, Using the work of an Auditor's Expert, the nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed between the auditor and the auditor's expert.

In certain situations, the need for a detailed agreement in writing is required like -

- The auditor's expert will have access to sensitive or confidential entity information.
- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

In the given case, considering the complexity involved in the valuation and volume of derivatives and also due to the fact that the auditor and auditor's expert were new to each other, auditor should have signed a formal agreement/ engagement letter with the auditor's expert in respect of the work assigned to him.

9. Audit Programme of Movie Theatre Complex:

(i) Peruse the Memorandum of Association and Articles of Association of the entity.

(ii) Ensure the object clause permits the entity to engage in this type of business.

(iii) In the case of income from sale of tickets:

(1) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly and accurately accounted.

(2) Verify the system relating to online booking of various shows and the system of realization of money.

(3) Check that there is overall system of reconciliation of collections with the number of seats available for different shows in a day.

(iv) Verify the internal control system and its effectiveness relating to the income from café, shops, pubs, game zone etc., located within the multiplex.

(v) Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.

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(vi) Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.

(vii) In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement, any payment of advance made to the distributor is also adjusted against the amount due.

(viii) Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.

(ix) Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

(x) Verify the insurance premium paid and ensure it covers the entire assets.

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CHAPTER 4

MATERIALITY, RISK ASSESSMENT AND INTERNAL CONTROL



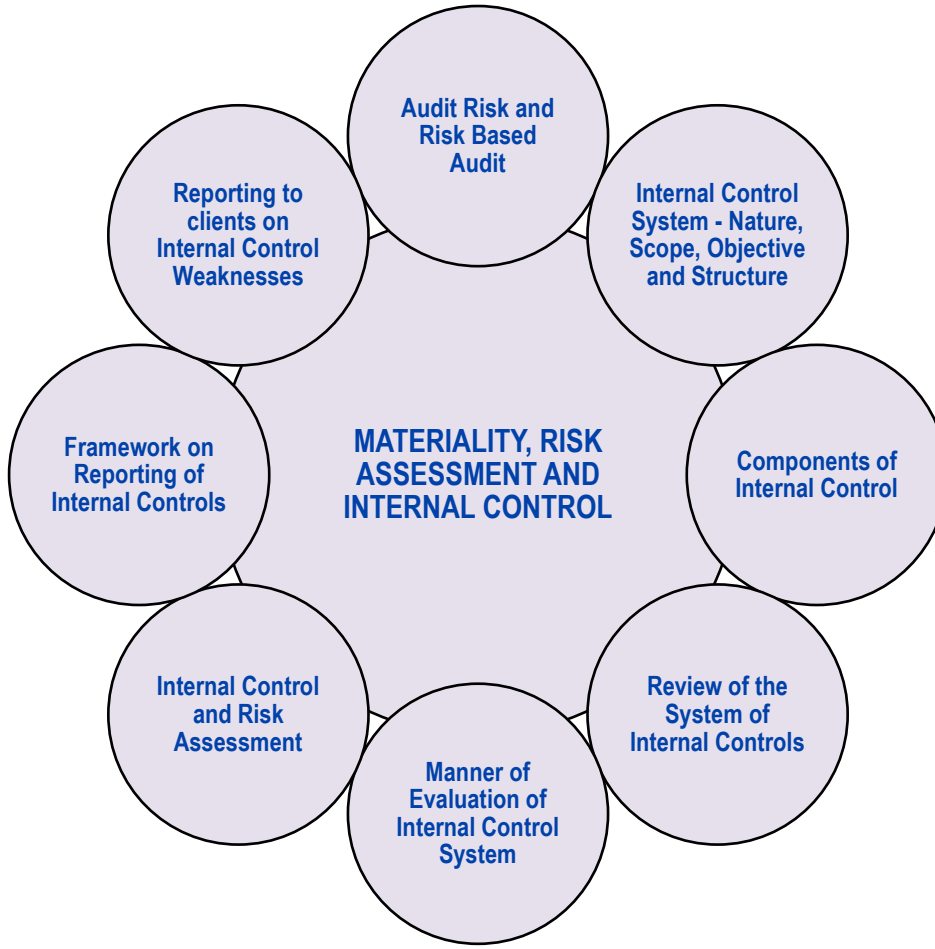
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the concept of Risk Based Audit, Internal Control and Risk Assessment.
- Identify the components of Audit Risk and Internal Control.
- Learn to review the systems of Internal Control.
- Know the Internal Control System-Nature, Scope, Objective and Structure.
- Gain knowledge of reporting to clients on Internal Control weaknesses.
- Know the framework of Reporting of Internal Control.
- Practicality of above concepts using examples and case study.

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CHAPTER OVERVIEW



CA Y, auditor of a company for the last three years, is set to assess audit risk for the engagement. Before he proceeded, a question struck his mind. Is such an exercise useful for him practically? How assessing audit risk is useful for an auditor every year? He seemed to be caught in SALY approach (Same as last year). Turning to a webinar on the topic helped him illuminate his insight. Not only assessing audit risk is mandatory under Standards on Auditing, but it also leads to audit effectiveness and audit quality. Besides, it helps auditors to plan audits in a better way.

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By understanding the company and its internal control, auditor can identify those areas which are prone to misstatements whether due to errors or frauds. The risk assessment need not be same as of last year due to new developments like change in laws, change in business model of the company or due to changes in industry in which the client company operates or due to other factors.

He also learnt how understanding business risks of the company and strategy formulated by the company to deal with business risks influences audit risk. Where the company has an established plan to deal with business risks peculiar to it, the auditor gains comfort regarding management's ability to deal with such business risks by evaluating such plans.

Evaluation of controls of a company helps auditor in zeroing in those areas where controls are deficient. It also aids in discovering those areas where controls may be missing and non-existent. If controls are not effective or are missing, risk of material misstatement also increases due to increase in control risk. By using needed risk assessment procedures like inquiries, inspection and observation, auditors can understand areas of risks of material misstatement. It would ultimately lead to performing an effective and qualitative audit.

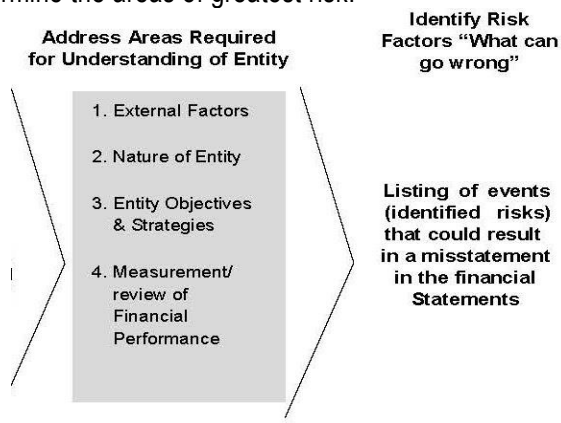
What happens when an auditor identifies significant deficiencies in the internal control system of the company? Besides having an impact on audit risk, auditor has also a responsibility to communicate such deficiencies to the management, to those responsible for governing the company. It may induce those sitting in board rooms to take note of the same and initiate corrective actions. Besides, such communications also end up saving auditor's skin. It is due to the reason that he has already taken pre-emptive steps in this regard. Significant deficiencies have already been communicated to management and this could come to defence of the auditor later.

1. MATERIALITY & RISK ASSESSMENT

As per SA 320, the concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. Materiality and audit risk are considered throughout the audit, in particular, when identifying and assessing the risks of material misstatement, determining the nature, timing and extent of further audit procedures; and evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

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Risk assessment assesses the level of risk in the various business processes. Risk assessment focuses on the business environment, regulatory environment, organisation structure, organizational and business environmental changes and specific concerns of management and the audit committee to determine the areas of greatest risk.



1.1 Identification of Risks

Audit risk is the risk of expressing an inappropriate audit opinion on financial statements that are materially misstated.

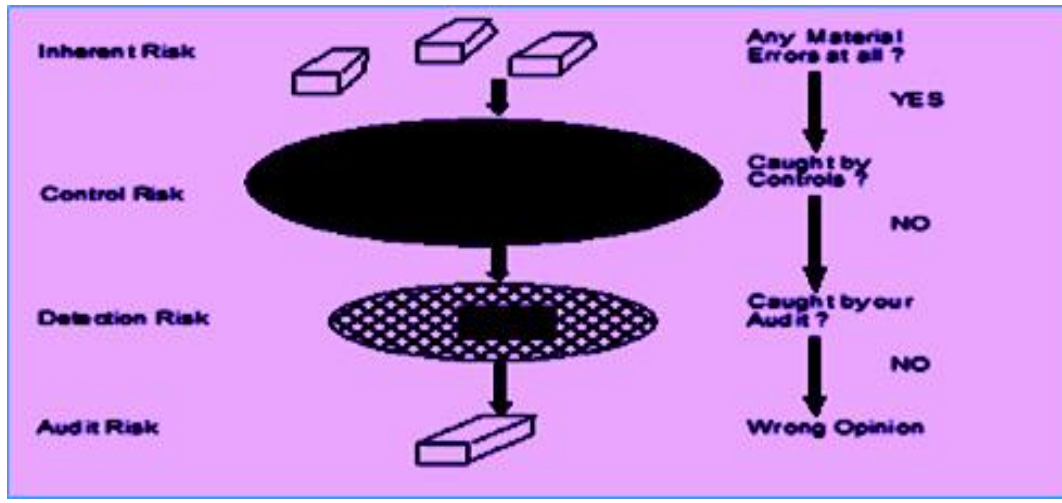


Fig.: Risks of Material Misstatement*

1.2 Audit Risk Components

The major components of audit risk are described in the Table below

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

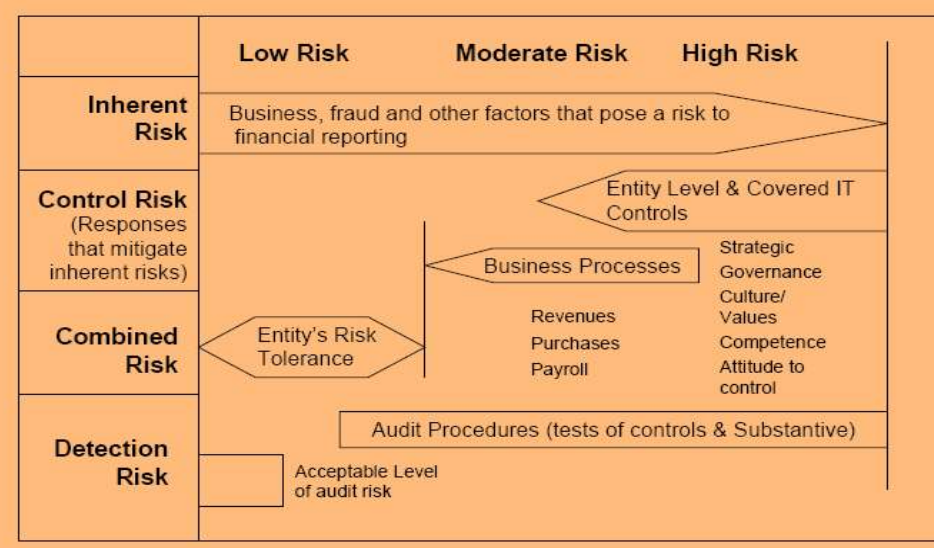
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Nature	Description	Commentary
Inherent Risk	Susceptibility of an assertion to a misstatement that could be material, individually or when aggregated with other misstatements, assuming that there are no related controls. Inherent risk is addressed at both the financial statement level and at the assertion level. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.	These are the business and other risks that arise from the entity's objectives, nature of operations and industry, the regulatory environment in which it operates and its size and complexity. The risks of material misstatement will vary based on the nature of the account balance or class of transaction. Risks of particular concern to the auditor might include: • Complex calculations which could be misstated; • High value inventory; • Accounting estimates that are subject to significant measurement uncertainty; • Lack of sufficient working capital to continue operations; • A declining or volatile industry with many business failures; and • Technological developments that might make a particular product obsolete.
Control Risk (Do internal controls in place mitigate the inherent risks?)	Risk that the entity's internal control system will not prevent, or detect and correct on a timely basis, a misstatement that could be material, individually or when aggregated with other misstatements.	The entity should identify and assess its business and other risks (such as fraud) and respond by designing and implementing a system of internal control. Entity level controls such as board oversight, IT general controls, and HR policies are pervasive to all assertions whereas activity level controls generally, relate to specific assertions. Some control risk will always exist

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		because of the inherent limitations of any internal control system. The auditor is required to understand the entity's internal control and perform procedures to assess the risks of material misstatement at the assertion level.
Detection Risk	This is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. The acceptable level of detection risk for a given level of audit risk bears an inverse relationship to the risks of material misstatement at the assertion level	The auditor identifies assertions where there are risks of material misstatement and concentrates audit procedures on those areas. In designing and evaluating the results of performing procedures, the auditor should consider the possibility of: • Selecting an inappropriate audit procedure; • Misapplying an appropriate audit procedure; or • Misinterpreting the results from an audit procedure.

Interrelationship of Audit Risk Components



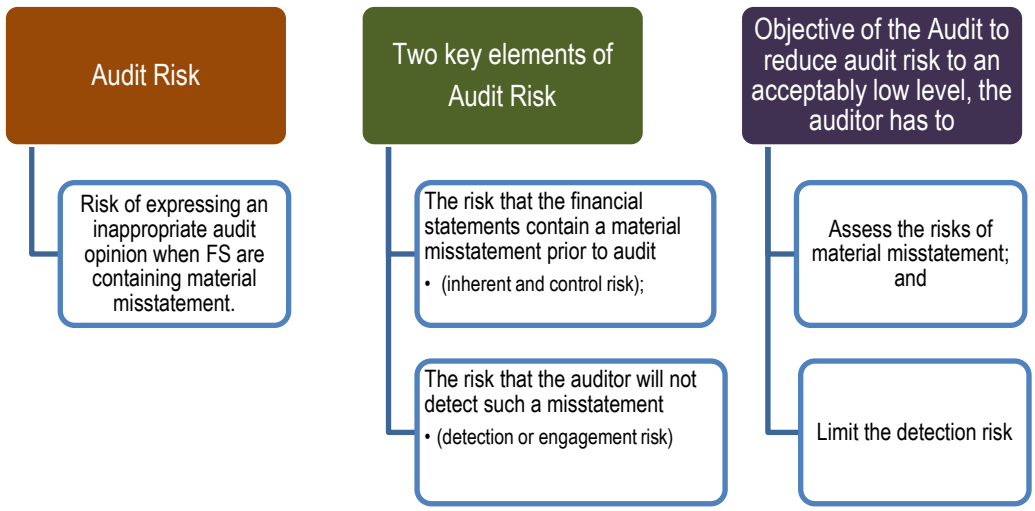
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Mathematically Audit Risk (AR) can be expressed as a product of Inherent Risk (IR), Control Risk (CR) and Detection Risk (DR), i.e. AR = IR x CR x DR

Audit Risk has two components: Risk of material misstatement (the risk that the financial statements contain a material misstatement Prior to Audit) and detection risk (the risk that the auditor will not be able to detect such misstatement).

The relationship can be defined as follows.

Audit Risk = Risk of Material Misstatement X Detection Risk
Risk of material Misstatement: - Risk of material misstatement is anticipated risk that a material misstatement may exist in financial statement before start of the audit. It has two components inherent risk and control risk. The relationship can be defined as **Risk of Material Misstatement = Inherent risk X Control risk**
Detection risk: It is a risk that a material misstatement remained undetected even if all audit procedures applied.
It should be noted that the combined level of Inherent Risk and Control Risk is inversely related with Detection Risk, and Audit Materiality is also inversely related with Audit Risk.



The objective of the audit is to reduce this audit risk to an acceptably low level. This may be achieved by performing procedures that respond to the assessed risks at the financial statement, class of transactions, account balance and assertion levels. Number of embedded assertions are included in management's representations about the financial statements. These relate to the

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recognition, measurement, presentation and disclosure of the various elements (amounts and disclosures) in the financial statements.



1. Management of ABC Ltd. may assert to the auditor that the sales balance in the accounting records contains all the sales transactions (completeness assertion), the transactions took place and are valid (occurrence assertion), and transactions have been properly recorded in the accounting records and in the appropriate accounting period (accuracy and cut-off assertion).

SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", categorises the types of assertions used by the auditor to consider the different types of potential misstatements that may occur, as follows:

Assertions about classes of transactions and events for the period under audit	**(i) Occurrence—**	**transactions and events that have been recorded have occurred and pertain to the entity.**
	(ii) Completeness—	**all transactions and events that should have been recorded have been recorded.**
	(iii) Accuracy—	**amounts and other data relating to recorded transactions and events have been recorded appropriately.**
	(iv) Cut-off—	**transactions and events have been recorded in the correct accounting period.**
	(v) Classification—	**transactions and events have been recorded in the proper accounts.**
Assertions about account balances at the period end	**(i) Existence—**	**assets, liabilities, and equity interests exist.**
	(ii) Rights and obligations—	**the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.**
	(iii) Completeness—	**all assets, liabilities and equity interests that should have been.**
	(iv) Valuation and allocation—	**assets, liabilities, and equity interests are included in the FS at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.**

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Assertions about presentation and disclosure	**(i) Occurrence and rights and obligations —**	**disclosed events, transactions, and other matters have occurred and pertain to the entity.**
	(ii) Completeness—	**all disclosures that should have been included in the financial statements have been included.**
	(iii) Classification and understandability—	**financial information is appropriately presented and described, and disclosures are clearly expressed.**
	(iv) Accuracy and valuation—	**financial and other information are disclosed fairly and at appropriate amounts."**

Auditors are required to assess the risks of material misstatement at two levels. The first is at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.



2. If the top accountant is not competent enough for the assigned tasks, it is quite possible that errors could occur in the financial statements. However, the nature of such errors will not often be confined to a single account balance, transaction stream or disclosure. In addition, the error is not likely be confined to a single assertion such as the completeness of sales. It could easily relate to other assertions such as accuracy, existence and valuation.

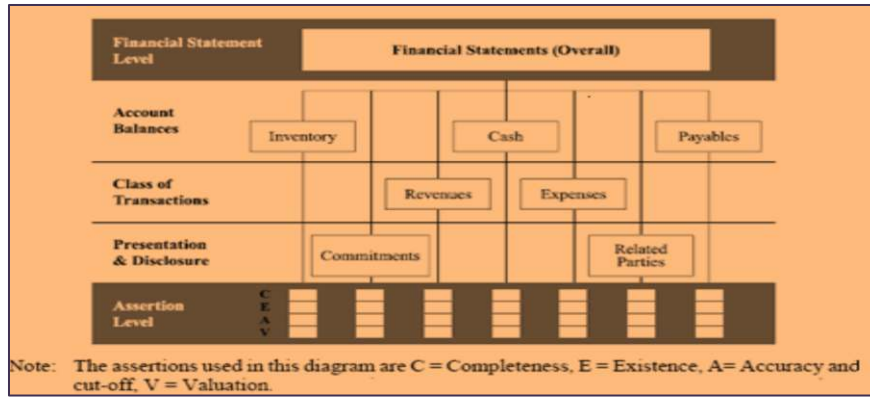
The second relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. This means that for each account balance, class of transactions and disclosure, an assessment of risk (such as high, moderate, or low) should be made for each individual assertion (C, E, A, and V in the diagram below) being addressed.



3. While considering the valuation assertion, the auditor could assess the risk of error in payables as low; however, for inventory where obsolescence is a factor, the auditor would assess the valuation risk as high. Another example would be where the risks of material misstatement due to completeness (missing items) in the inventory balance are low, but high in relation to the sales balance.

The difference between assessing risk at the overall financial statement level and the assertion level is illustrated (in partial form only) below.

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1.3 Steps for Risk Identification

- Assess the significance of the assessed risk, impact of its occurrence and also revise the materiality accordingly for the specific account balance.
- Determine the likelihood for assessed risk to occur and its impact on auditing procedures.
- Document the assertions that are affected.
- Consider the impact of the risk on each of the assertions.
- (completeness, existence, accuracy, validity, valuation and presentation) relevant to the account balance, class of transactions, or disclosure.
- Identify the degree of significant risks that would require separate attention and response by the auditor. Planned audit procedures should directly address these risks.
- Enquire and document the management's response.
- Consider the nature of the internal control system in place and its possible effectiveness in mitigating the risks involved. Ensure the controls:
  - Routine in nature (occur daily) or periodic such as monthly.
  - Designed to prevent or detect and correct errors.
  - Manual or automated.
- Consider any unique characteristics of the risk.
- Consider the existence of any particular characteristics (inherent risks) in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures.

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- Examples could include high value inventory, complex contractual agreements, absence of a paper trail on certain transaction streams or a large percentage of sales coming from a single customer.

Possible potential misstatements - Indicators

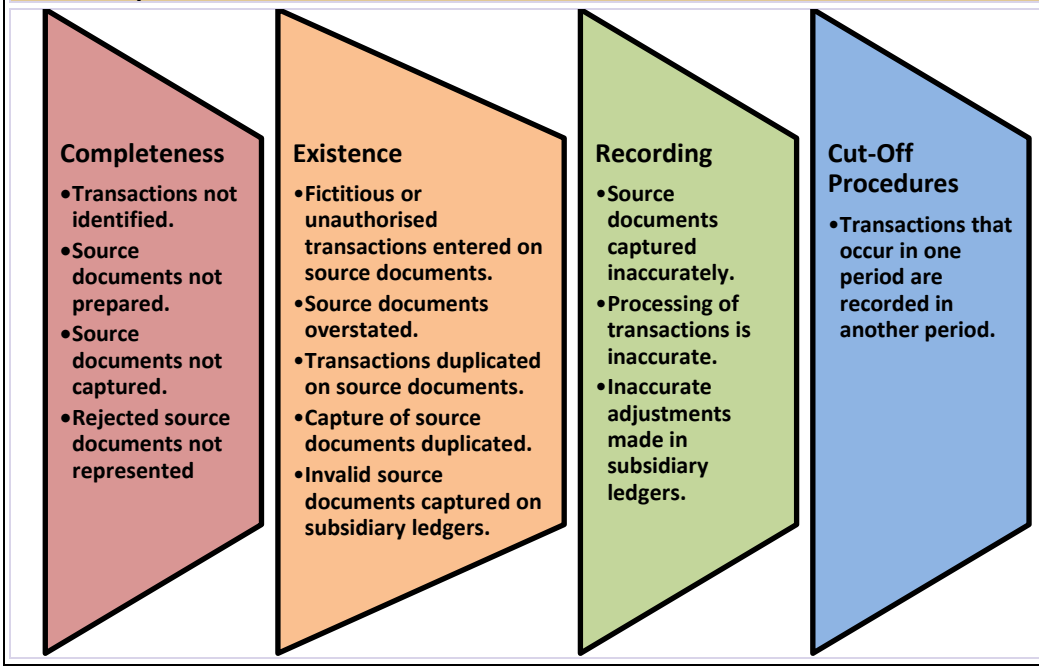


ILLUSTRATION 1

Background: *During the process of extracting the exception reports, the auditors noted numerous purchase entries without valid purchase orders.*

Analysis: *In terms of percentage, about 40% of purchases were made without valid purchase orders and also few purchase orders were validated after the actual purchase. Also, there was no reconciliation between the goods received and the goods ordered.*

Assertions: *Validity of purchases*

Pervasive/Account Balance Level: *Account Balance level*

Account Balance(s) affected: *(i) Purchases, (ii) Account Payable*

Audit Procedures: *The following procedures may address the validity of the account balance:*

- *Make a selection of the purchases, review correspondence with the vendors, purchase requisitions (internal document) and reconciliations of their accounts.*

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- *Review Vendor listing along with the ageing details. Follow up the material amounts paid before the normal credit period and analyse the reasons for exceptions.*
- *Meet with the company's purchase officer and obtain responses to our inquiries regarding the purchases made without purchase orders.*
- *Discuss the summary of such issues with the client.*

2. RISK-BASED AUDIT APPROACH

Audit should be risk-based or focused on areas of greatest risk to the achievement of the audited entity's objectives. Risk-based audit (RBA) is an approach to audit that analyzes audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas.

The auditor does not normally need to perform specific audit procedures on all areas of audit. He only needs to design audit programmes and procedures on areas earlier identified as major risks that could result in the financial statements being materially misstated.

Risk Based Audit is an essential element of financial audit- both in the attest audit of the financial statements and in the audit of financial systems and transactions including evaluation of internal controls. It focuses primarily on the identification and assessment of the financial statement misstatement risks and provides a framework to reduce the impact on the financial statements of these identified risks to an acceptable level before rendering an opinion on the financial statements. It also provides indicators of risks as a basis of opportunity for improvement of auditee risk management and control processes. This affords an opportunity to the auditee to improve its operations from recommendations on risks that do not have a current impact on the financial statements but impact the audited entity's operational strategies and performance over the longer term.

In the context of performance audit, it is the risk to delivery of an activity or scheme or programme of the entity with economy, efficiency and effectiveness. Awareness of areas that puts the programme or resources at risk from the point of view of economy, efficiency and effectiveness helps focus audit attention on them. The risk analysis provides a framework for assurance in performance auditing.

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2.1 Audit Risk Analysis

The auditor should perform an analysis of the audit risks that impact on the auditee before undertaking specific audit procedures. Risk assessment is a subjective process. It is part of the professional judgment of the auditor and of the particular circumstances. It is the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated.

Audit risks are brought about by error and fraud:
♦ Error is an unintentional mistake resulting from omission, as when legitimate transactions and/or balances are excluded from the financial statements; or by commission, as when erroneous transactions and/or balances are included in the financial statements.
♦ Fraud is an intentional misstatement in the accounting records or supporting documents from which the financial statements are prepared. It is intended to deceive financial statement users or to conceal misappropriations.

The auditor has the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

An error risk may arise from an error in principle, estimate, critical information processing, financial reporting process or disclosure.

Fraud risk involves manipulation, falsification of accounting records, or misrepresentation in the financial statements of events, transactions or other significant information, or misapplication of accounting principles or misappropriation of funds.

2.2 General Steps in the Conduct of Risk Based Audit

The auditor's objective in a risk-based audit is to obtain reasonable assurance that no material misstatements whether caused by fraud or errors exist in the financial statements.

This involves the following three key steps:

- Assessing the risks of material misstatement in the financial statements;
- Designing and performing further audit procedures that respond to assessed risks and reduce the risks of material misstatements in the financial statements to an acceptably low level; and
- Issuing an appropriate audit report based on the audit findings.

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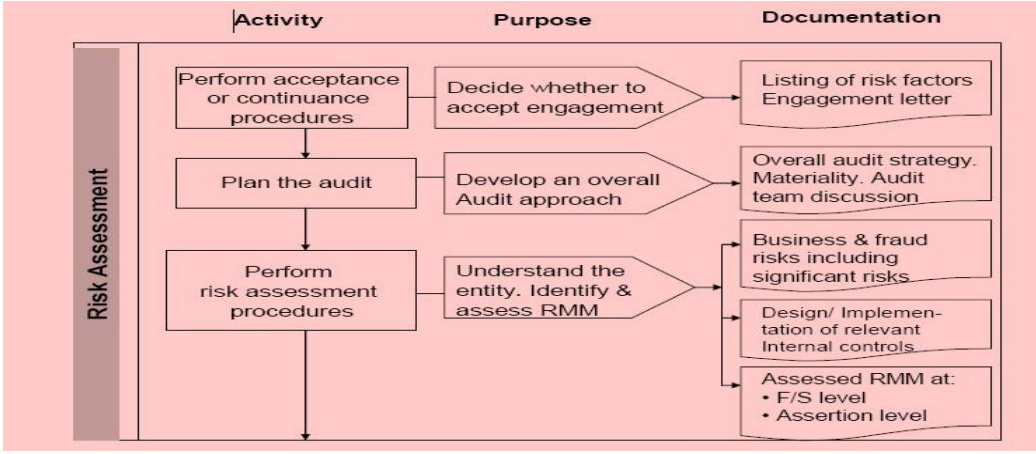
The risk-based audit process is presented in three distinct phases:

- Risk assessment.
- Risk response; and
- Reporting.

2.2.1. Risk Assessment

The risk assessment phase of the audit involves the following steps:

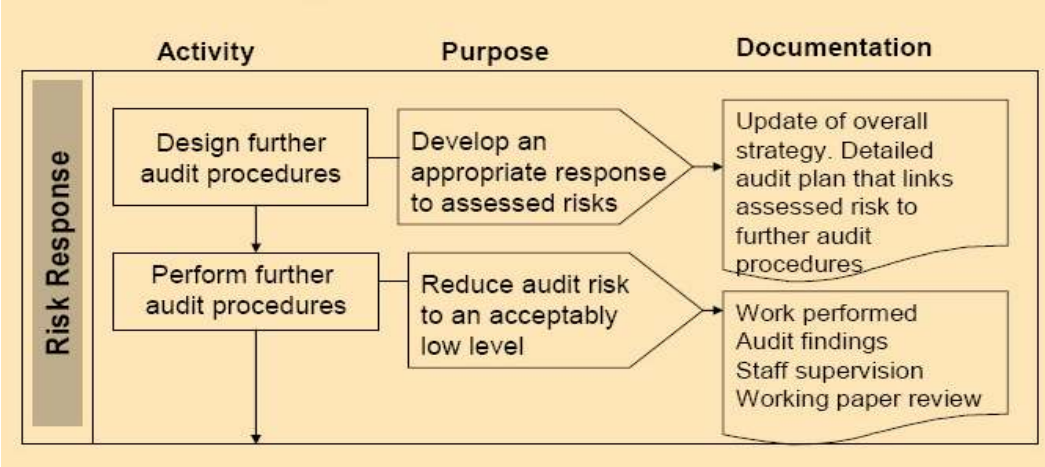
- Performing client acceptance or continuance procedures;
- Planning the overall engagement;
- Performing risk assessment procedures to understand the business and identify inherent and control risks;
- Identifying relevant internal control procedures and assessing their design and implementation (those controls that would prevent material misstatements from occurring or detect and correct misstatements after they have occurred);
- Assessing the risks of material misstatement in the financial statements;
- Identifying the significant risks that require special audit consideration and those risks for which substantive procedures alone are not sufficient;
- Communicating any material weaknesses in the design and implementation of internal control to management and those charged with governance; and
- Making an informed assessment of the risks of material misstatement at the financial statement level and at the assertion level.



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2.2.2. Risk response

This phase of the audit is to design and perform further audit procedures that respond to the assessed risks of material misstatement and will provide the evidence necessary to support the audit opinion.



Some of the matters the auditor should consider when planning the audit procedures include:

- Assertions that cannot be addressed by substantive procedures alone. This can occur where there is highly automated processing of transactions with little or no manual intervention.
- Existence of internal control that, if tested, could reduce the need/scope for other substantive procedures.
- The potential for substantive analytical procedures that would reduce the need/scope for other types of procedures.
- The need to incorporate an element of unpredictability in procedures performed.
- The need to perform further audit procedures to address the potential for management override of controls or other fraud scenarios.
- The need to perform specific procedures to address "significant risks" that have been identified.

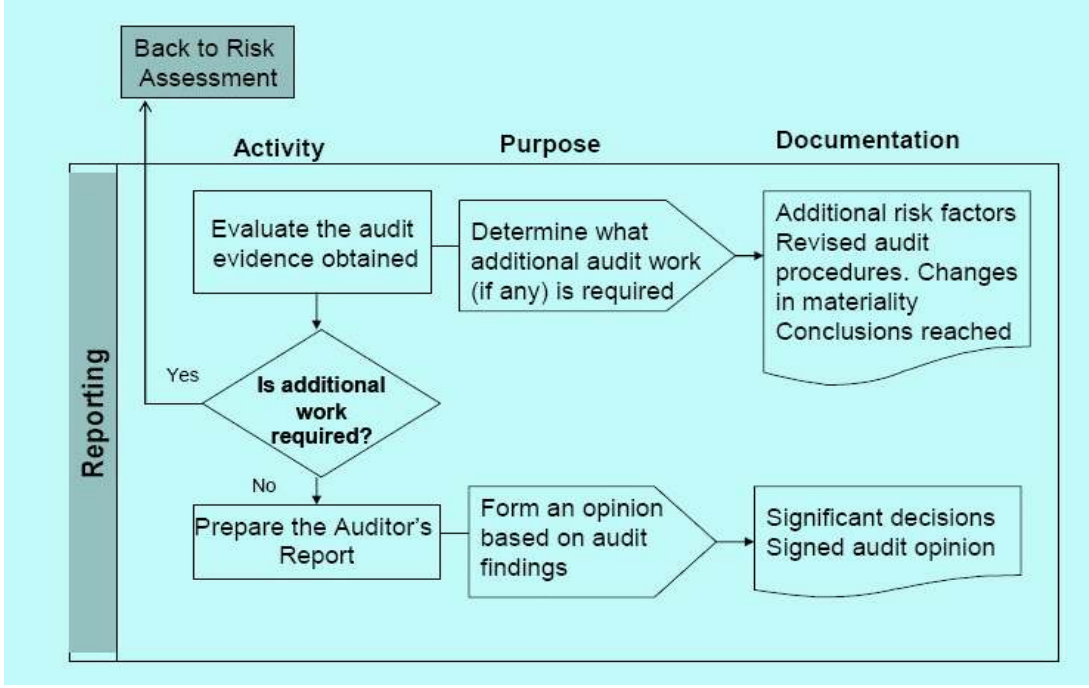
Audit procedures designed to address the assessed risks could include a mixture of:
• Tests of the operational effectiveness of internal control; and
• Substantive procedures such as tests of details and analytical procedures.

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example

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

2.2.3. Reporting



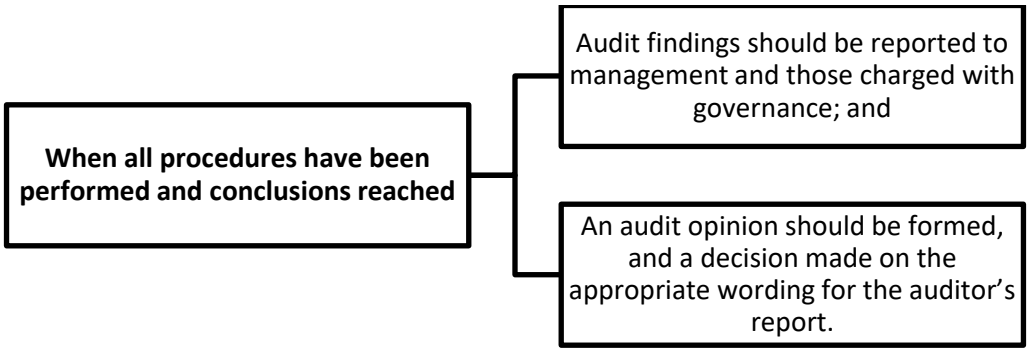
The final phase of the audit is to assess the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the overall Audit Risk to an acceptably low level.

It is important at this stage to determine:

- If there had been a change in the assessed level of risk;
- Whether conclusions drawn from work performed are appropriate; and
- If any suspicious circumstances have been encountered.

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Any additional risks should be appropriately assessed, and further audit procedures performed as required.



TEST YOUR UNDERSTANDING 1

CA R is conducting statutory audit of a Divisional office (DO) of a public sector insurance company. On going through delegation of powers laid down by company's head office, it is noticed that surveyors in claims under property insurance policies beyond estimated amounts of ₹30 lac are to be appointed by Divisional Claims Committee (DCC). However, ongoing through surveyor appointment details of 10 such claims during the year, 5 instances have come to his notice where above delegation of powers has not been followed and appointments were made by Divisional manager in place of DCC.

In the beginning, the auditor had assessed risks of material misstatement to be low. Describe why the above finding would change auditor's assessment in relation to above.

TEST YOUR UNDERSTANDING 2

You have recently been appointed as an auditor of NGO working in the field of "upholding democracy" for the first time. The last year accounts of NGO were unaudited and its activities were limited at a small scale. However, it is only in the current year that NGO has received substantial donations including foreign funds. The said NGO is also crowdfunding its donations. The government has now legislative power to cancel FCRA certificate of NGO. Since it is working in a field which encompasses political and social fields, accusations and counter-accusations are flying thick and fast.

What factors you may consider for assessing audit risk?

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3. INTERNAL CONTROL SYSTEM - NATURE, SCOPE, OBJECTIVES AND STRUCTURE

Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met.



"Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

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

To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the framework. The Accounting Standards specified under the Companies Act, 2013 is one of the criteria constituting the financial reporting framework on which companies prepare and present their financial statements under the Act and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and the results of operations of the company in an audit of the financial statements carried out under the Act.

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

Ordinarily, development of the overall audit plan does not require an understanding of control procedures for every financial statement assertion in each account balance and transaction class.

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An auditor's judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of misstatement. The auditor should obtain audit evidence through tests of control to support any assessment of control risk which is less than high. The lower the assessment of control risk, the more evidence the auditor should obtain that accounting and internal control systems are suitably designed and operating effectively.

When obtaining audit evidence about the effective operation of internal controls, the auditor considers :

how they were applied,	**the consistency with which they were applied during the period and**	**by whom they were applied.**

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

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



5. The auditor might obtain audit evidence about the proper segregation of duties by observing the individual who applies a control procedure or by making inquiries of appropriate personnel. However, audit evidence obtained by some tests of control, such as observation, pertains only to the point in time at which the procedure was applied. The auditor may decide, therefore, to supplement these procedures with other tests of control capable of providing audit evidence about other periods of time.

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

The following are the Nature, Scope, Objectives and Structure of an Internal Control System:

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3.1 Nature of Internal Control

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

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

3.2 Scope of Internal Controls

The scope of internal controls extends beyond mere accounting controls and includes all administrative controls concerned with the decision-making process leading to managements authorization of transaction, such controls include, production method, time and motion study, pricing policies, quality control, work standard, budgetary control, policy appraisal, quantitative controls etc.

In an independent financial audit, the auditor is primarily concerned with those policies and procedures having a bearing on the assertions underlying the financial statements. These comprise primarily controls relating to safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records and timely preparation of reliable financial information. Administrative controls, on the other hand, have only a remote relationship with financial records and the auditor may evaluate only those administrative controls which have a bearing on the reliability of the financial records.

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

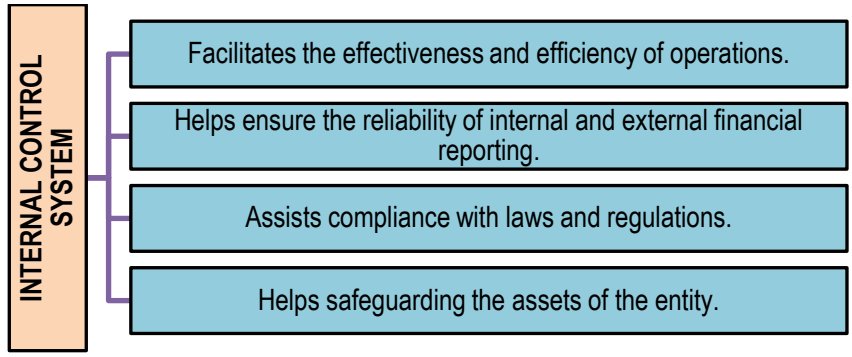
Fundamental to a system of internal control is that it is integral to the activities of the company, and not something practiced in isolation.



6. If production statistics were used as a basis for an analytical procedure, the controls to ensure the accuracy of such data would be relevant.

If non-compliance with certain laws and regulations has a direct and material effect on the financial statements, the controls for detecting and reporting on such non-compliance would be relevant.

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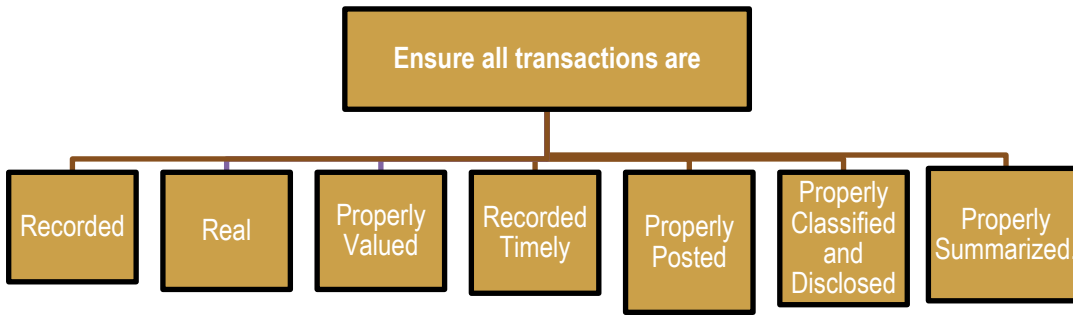


3.3 Objectives of Internal Control System

The objectives of internal control system are determined by the management, after considering the nature of business, scale operations, the extent of professionalism of the management etc.

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

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



If the response to all the above answers is positive, the auditor would be justified in limiting his account balance tests considerably.

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In the case of excellent companies, where in a system a particular control is found to be deficient, audit attention can be focused on the areas where basic accounting control objectives are not being adhered to.



7. In case, if it found that sales transactions are not being properly valued in accordance with the price list determined by the management, the auditor would have to perform extensive searching tests on sales invoices to assure himself that the recoverable amounts are correctly posted. He may also want to expand his confirmation request at the year end to cover a large majority of trade receivables.

3.3.1 Limitations of Internal Control - Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives.

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

3.4 Structure of Internal Control

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

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

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(a) authorization of transactions;

(b) execution of transactions;

(c) physical custody of related assets; and

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

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

3.4.2 Authorization of Transaction - Delegation of authority to different levels and to particular persons are required to establish by the management for controlling the execution of transaction in accordance with prescribed conditions. Authorization may be general or it may be specific with reference to a single transaction. It is necessary to establish procedures which provide assurance that authorizations are issued by persons acting within the scope of their authority, and that the transactions conform to the terms of the authorizations. This objective can be achieved by making independent comparison of transaction document with general or specific authorizations, as the case may be.

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

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

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(vii) Records of assets such as sufficient description of the assets (to facilitate identification) its location should also be maintained so that the assets could be physically verified periodically.

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

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

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

4. COMPONENTS OF INTERNAL CONTROLS

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

(i) Control Environment;

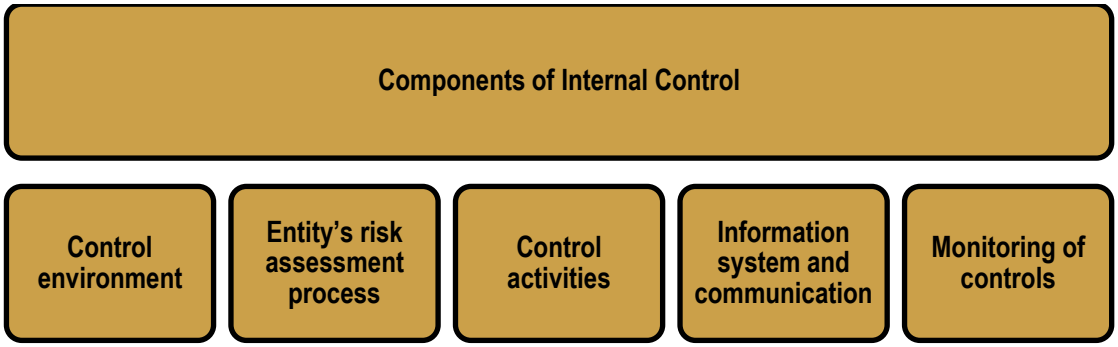
(ii) Entity's Risk Assessment Process;

(iii) Control Activities;

(iv) Information System and Communication;

(v) Monitoring of Controls

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4.1 Control Environment

The control environment encompasses the following elements:

(a) **Communication and enforcement of integrity and ethical values:** The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.

(b) **Commitment to competence:** Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.

(c) **Participation by those charged with governance:** An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.

(d) **Management's philosophy and operating style:** Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.

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(e) **Organisational structure:** Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.

(f) **Assignment of authority and responsibility:** The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

(g) **Human resource policies and practices:** Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behaviour – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behaviour. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

4.2 Entity's Risk Assessment Process

For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof.



8. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements.

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

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and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations.

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

4.3 Control Activities

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

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(a) **Performance reviews:** These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.

(b) **Information processing:** The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

(c) **Physical controls:** Controls that encompass:

- The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
- The authorisation for access to computer programs and data files.
- The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records). The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.

(d) **Segregation of duties:** Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation

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controls may be delegated under established guidelines, such as, investment criteria set by those charged with governance; alternatively, non-routine transactions such as, major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

4.4 Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).

The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:	
(a)	Identify and record all valid transactions.
(b)	Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
(c)	Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
(d)	Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
(e)	Present properly the transactions and related disclosures in the financial statements.

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

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

4.5 Monitoring of Controls

An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of

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controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

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

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

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

1. Internal Check System - Internal check system implies organization of the overall system of book-keeping and arrangement of staff duties in such a way that no one person can carry through a transaction and record every aspect thereof. It is a part of the overall control system and operates basically as a built-in-device as far as organization and job-allocation aspects of the controls are concerned.

The system provides existence of checks on the day-to-day transactions which operate continuously as part of the routine system whereby the work of each person is either proved independently or is made complimentary to the work of another.

The following are the objectives of the internal check system:
(i) To detect error and frauds with ease.
(ii) To avoid and minimize the possibility of commission of errors and fraud by any staff.

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(iii)	To increase the efficiency of the staff working within the organization.
(iv)	To locate the responsibility area or the stages where actual fraud and error occurs.
(v)	To protect the integrity of the business by ensuring that accounts are always subject to proper scrutiny and check.
(vi)	To prevent and avoid the misappropriation or embezzlement of cash and falsification of accounts.

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

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

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

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

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

The general condition pertaining to the internal check system may be summarized as under:	
(i)	no single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.
(ii)	Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time.
(iii)	Every member of the staff should be encouraged to go on leave at least once a year.
(iv)	Persons having physical custody of assets must not be permitted to have access to the books of accounts.

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(v)	There should exist an accounting control in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.
(vi)	Mechanical devices should be used, wherever practicable to prevent loss or misappropriation of cash.
(vii)	Budgetary control should be exercised and wide deviations observed should be reconciled.
(viii)	For inventory taking, at the close of the year, trading activities should, if possible be suspended, and it should be done by staff belonging to several sections of the organization.
(ix)	The financial and administrative powers should be distributed very judiciously among different officers and the manner in which those are actually exercised should be reviewed periodically.
(x)	Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

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

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

Note: For a detailed discussion on internal audit refer Chapter on Internal Audit in Module 3.

TEST YOUR UNDERSTANDING 3

RK Living Limited is engaged in manufacturing and processing of textile fabrics. It purchases its raw material from a company based in Silvassa taxable @ 12%. It takes about 3-4 days for raw materials to reach the company's plant. Recently, the company has revamped its internal control

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system for recording its transactions. You have also assumed charge as head of the internal audit department of the company a few days before.

It is noticed that the information system requires booking of purchases in purchase ledger and stock records from date of purchase invoice only. How would you deal with the above matter as internal auditor of the company?

TEST YOUR UNDERSTANDING 4

A company as part of its internal control set up has a system under which quarterly budgeted targets in respect of sales are analysed with respect to actual performance achieved. It also involves fixing responsibilities of different product departmental heads and taking timely correction. In case of product departmental heads not achieving quarterly budgeted targets, they have to give a detailed justification for the same and also lay down how shortfalls would be compensated in ensuing quarters.

Identify and explain component of internal control alluded to in above scenario.

5. REVIEW OF THE SYSTEM OF INTERNAL CONTROLS

The control environment sets the tone of an organization, influencing the control consciousness of its people. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

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

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

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

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

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

The review of the internal control system enables the auditor -

(i) to formulate his opinion as to the reliance he may place on the system itself i.e. whether the system is such as would enable the management to produce a true and fair set of financial statements; and

(ii) to locate the areas of weakness in the system so that the audit programme and the nature, timing and extent of substantive and compliance audit procedures can be adjusted to meet the situation.



9. If the auditor is not satisfied with the control system as regards trade receivable, he may decide to have a wider coverage for confirmation of trade receivables' balances. Normally, investments and cash are physically verified at the end of the period and this routine is known to the client and his employees. In case the auditor comes across a weakness in the control either he may provide in the programme for a surprise cash count or investment verification on a day preceding or succeeding the routine verification. In such a case, a surprise check will be more useful if it is undertaken after the routine verification is over. Similarly, if he is of the view that because of weak controls the possibility of wrong billing to customers exists, be may extend the programme for comparison of the invoices with the forwarding notes and for checking of the extensions and castings of the invoices.

Deciding the point of time appropriate for undertaking the review of the internal controls is a matter for individual judgement of the auditor. This decision can be taken on a consideration of the size

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

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

(a) Any change in the system of internal control from that record in the appropriate section of the internal control questionnaire.

(b) Any further weakness noted in the internal control.

(c) Any instance where the prescribed system or procedure has not been followed.

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

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

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techniques are used to record information relating to an internal control system. Selection of a particular technique is a matter for the auditor's judgement.

6. INTERNAL CONTROL ASSESSMENT & EVALUATION



The quality & effectiveness of internal controls is directly dependent on the organisational environment. The tone at the top (the Board & Executive Management) & the credibility of the message on internal controls from top plays a vital role in establishing a strong control environment. Some of the key components to assess & evaluate the controls environment are as under:

1. **Standard Operating Procedures (SOPs):** A well-defined set of SOPs helps outline role, responsibilities, process and controls. This ensures that operating controls are clearly communicated to all touch points of a process. SOPs promote consistent application of controls even during employee turnover, reducing the risk of disruptions.

2. **Enterprise Risk Management:** An organization which has robust process to identify & mitigate risks across the enterprise & its periodical review will assist in early identification of gaps & taking effective control measures. In such organizations, surprises of failures in controls are likely to be few.

3. **Segregation of Job Responsibilities:** A key element of control is that multiple activities in a transaction/decision should not be concentrated with one individual. Segregation of duties is an important element of control such that no two commercial activities should be conducted by the same person.



10. A buyer should not be involved in receiving of materials or passing of bills. Similarly bank reconciliation should be prepared by a person other than the one who maintains bank book.

4. **Job Rotation in Sensitive Areas:** Any job carried out by the same person over a long period of time is likely to lead to complacency & possible misuse in sensitive areas. It is therefore important that in key commercial functions, the job rotation is regularly followed to avoid degeneration of controls.

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If the same buyer continues to conduct purchase function for long period, it is likely that he gets into comfort zone with existing vendors & hence does not exercise adequate controls in terms of vendor development, competitive quotes etc.

5. **Delegation of Financial Powers Document**: As the organization grows, it needs to delegate the financial & other powers to employees. A clearly defined document on delegation of powers allows controls to be clearly operated without being dependent on individuals.

6. **Information Technology based Controls**: With the advent of computers & enterprise resource planning (ERP) systems, it is much easier to embed controls through the system instead of being human dependent. The failure rate for IT embedded controls is likely to be low, is likely to have a better audit trail & is thus easier to monitor. **For example,** at the stage of customer invoicing, application of correct rates in invoices or credit control can all be exercised directly through IT system improving control environment.

6.1 Techniques of Evaluation of Internal Control

The following are the techniques of evaluation of internal control:

6.1.1 Questionnaire

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

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

In the use of standardized internal control questionnaire, certain basic assumptions about elements of good control are taken into account. These are -	
(i)	Certain procedures in general used by most business concerns are essential in achieving reliable internal control. This is a time-tested assumption. Deposit into bank of the entire receipts of a day or daily balancing of the cash book and ledgers or periodic reconciliation with the control accounts are examples of widely used practices which are considered good internal control practices. Besides, basic operations giving rise to these practices exist in all businesses irrespective of their nature.
(ii)	Organisations are such that permit an extensive division of duties and responsibilities. The larger the organisation, the greater is the scope of such division.
(iii)	Employees concerned with accounting function are not assigned any custodial function.
(iv)	No single person is thrust with the responsibility of completing a transaction all by himself.
(v)	There should always be evidence to identify the person who has done the work whether involving authorisation, implementation or checking.
(vi)	The work performed by each one is expected to come under review of another in the usual course of routine.
(vii)	There is proper documentation and recording of the transactions.

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The questionnaire serves the purpose of a record so far as the auditor is concerned about the state of internal control as given to him officially. A question naturally arises as to whether it is necessary to issue questionnaire for every year of the auditor's engagement.

For the first year of engagements, issue of questionnaire is necessary.

For subsequent years, the auditor, instead of issuing a questionnaire again, may request the client to confirm whether any change in the nature and scope of business has taken place that necessitated a corresponding change in the control system, or whether, even without a change in the nature and scope of business, the control system has undergone a change.

If there has been a change, the auditor should take note of its and enter appropriate comments on the relevant part of the questionnaire. However, it would be a good practice in the case of continuing engagements to issue a questionnaire irrespective of any change, say, every third year. This will obviate unnecessary trouble of filling the answers every time and to that extent the client's and the auditor's own time will be saved. The rationale for issuance of a questionnaire every three years, in the case of even no change, lies in altering the client as regards unnoticed and unspectacular changes that might have taken place during the intervening period; also this will make the client more control-conscious. Questionnaires can be prepared for various aspects of the internal control system.

6.1.2 Check List

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



11. Questions in the check list may be formed in the following manner (this is an illustrative set of questions to be answered by the audit staff).

Have you checked that the cashier -

(i) is not responsible for opening the incoming mails;

(ii) does not authorise any of the ledgers;

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(iii) does not authorise any expenditure or receipt;

(iv) does not sign cheques;

(v) takes his annual leave regularly;

(vi) inks and balances the cash book everyday;

(vii) verifies physical cash balance with the book figure daily at the end of the day;

(viii) prepares monthly bank reconciliation statement;

(ix) holds no other funds or investment;

(x) holds no unnecessary balance in hand;

(xi) does not pay money without looking into compliance with proper procedure and due authorisation; and

(xii) has tendered proper security or has executed a fidelity bond?

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

The basic distinction between internal control questionnaire and check list are as under:
1. The ICQ incorporates a large number of detailed questions but the check list generally contains questions relating to the main control objective with the area under review.
2. In ICQ, questions are usually answered by company executives. However, in a check list, the same are required to be answered by auditor/auditor staff.
3. The significance of 'No' in an ICQ does indicate a weakness but the significance of that weakness is not revealed automatically. However, in the check list, a specific statement is required where an apparent weakness may prove to be material in relation to the accounts as a whole.

6.1.3 Flow chart

The flow-charting technique can also be resorted to for evaluation of the internal control system. It is a graphic presentation of internal controls in the organisation and is normally drawn up to show the controls in each section or sub-section. As distinct from a narrative form, it provides the most concise and comprehensive way for reviewing the internal controls and the evaluator's findings. In a flow chart, narratives, though cannot perhaps be totally banished are reduced to the minimum and by that process, it can successfully bring the whole control structure, especially the essential

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parts thereof, in a condensed but wholly meaningful manner. It gives a bird's eye view of the system and is drawn up as a result of the auditor's review thereof. It should, however, not be understood that details are not reflected in a flow chart. Every detail relevant from the control point of view and the details about how an operation is performed can be included in the flow chart. Essentially a flow chart is a diagram full with lines and symbols and, if judicious use of them can be made, it is probably the most effective way of presenting the state of internal controls in the client's organisation.

A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically, it can show-

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

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

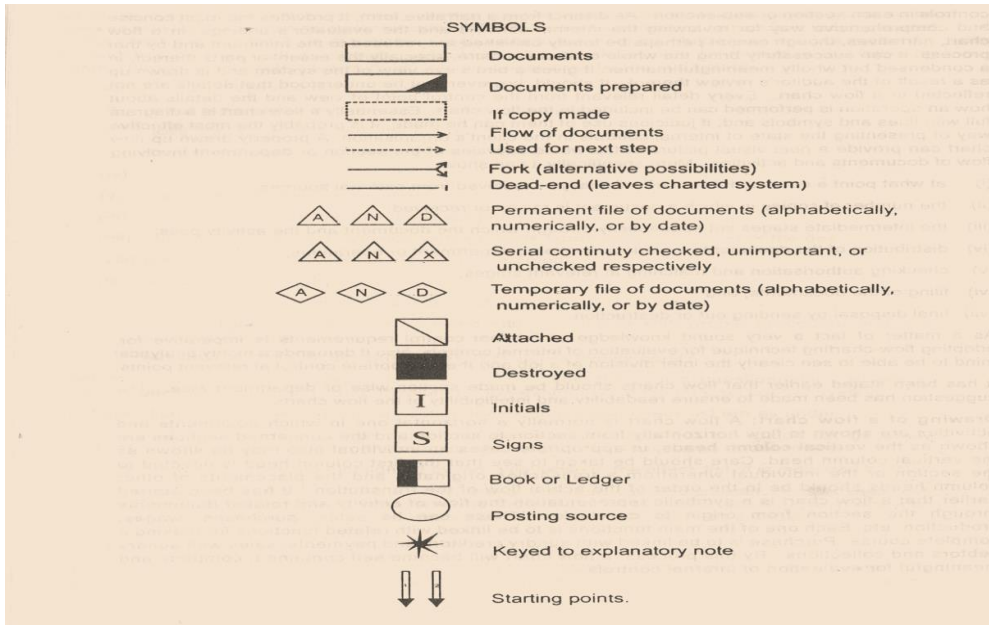
It has been stated earlier that flow charts should be made section-wise or department-wise. This suggestion has been made to ensure the readability and intelligibility of the flow charts.

Drawing of a flow chart - A flow chart is normally a horizontal one in which documents and activities are shown to flow horizontally from section to section and the concerned sections are shown as the vertical column heads; in appropriate cases an individual also may be shown as the vertical column head. Care should be taken to see that the first column head is devoted to the section or the individual wherefrom a transaction originates, and the placements of other column heads should be in the order of the actual flow of the transaction.

It has been started earlier that a flow chart is a symbolic representation of the flow of activity and related documents through the section from origin to conclusion. These can be sales, purchases, wages, production, etc. Each one of the main functions is to be linked with related functions for making a complete course. Purchase is to be linked with trade payables and payments, sales with

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trade receivables and collections. By this process, a flow chart will become self-contained, complete and meaningful for evaluation of internal controls.



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

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

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

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

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(i) through mail;

(ii) by telephone; and

(iii) through the company's salesmen.

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

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

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

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

The flow chart for the above may be as under -

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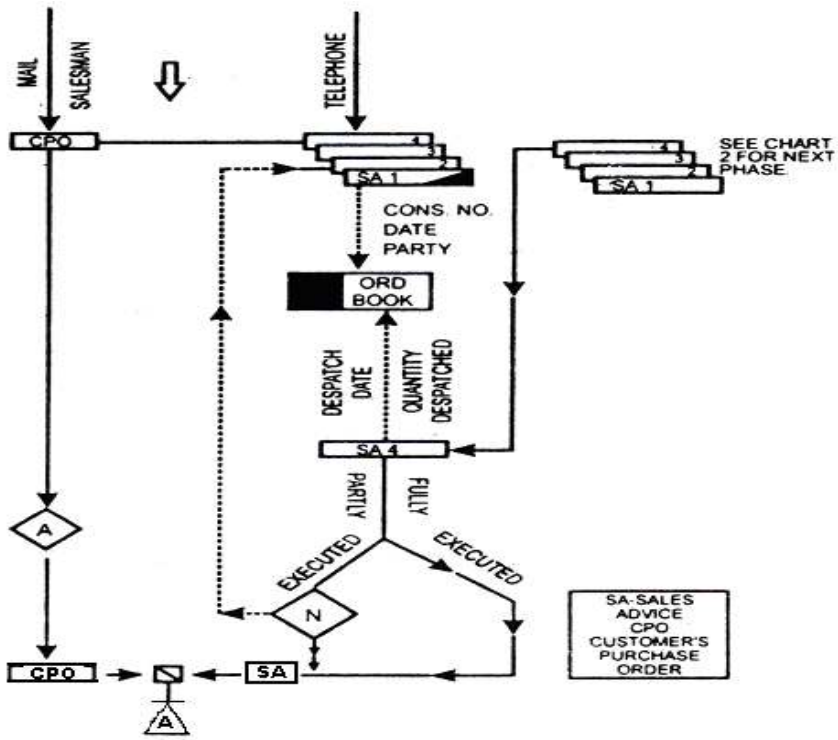


CHART 1

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

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

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

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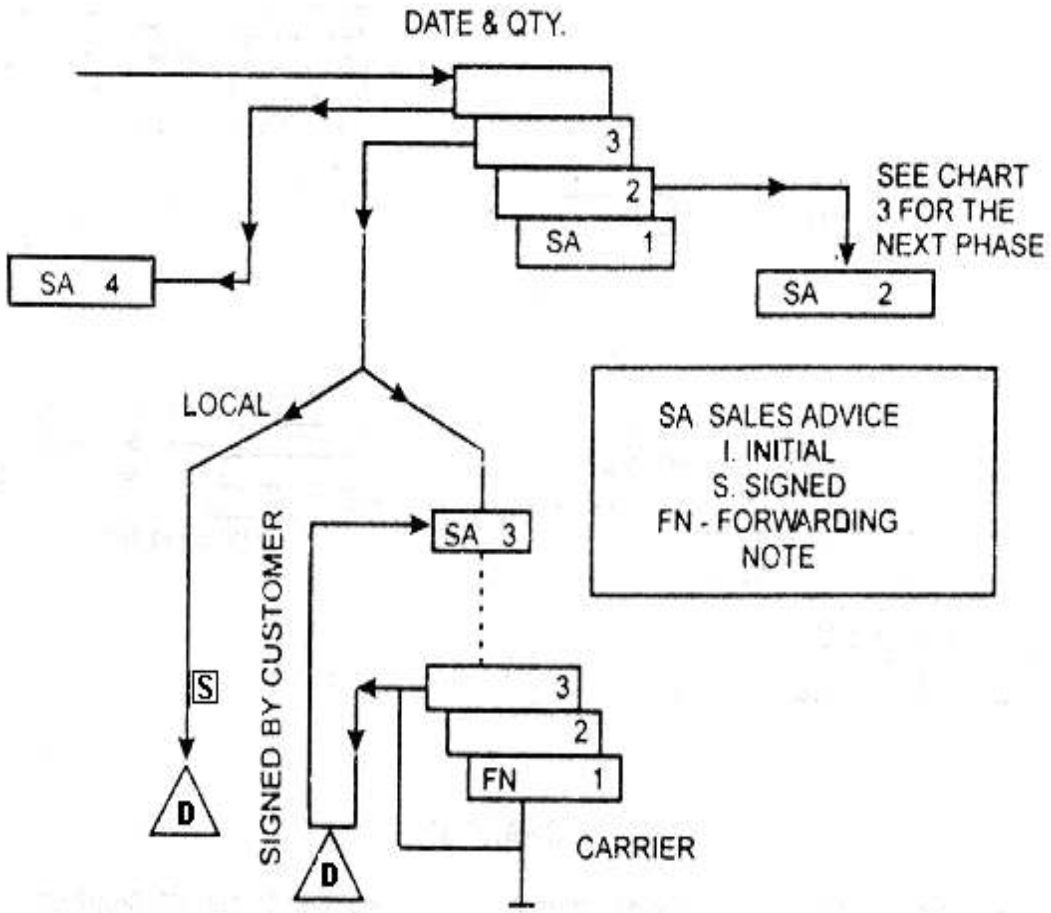


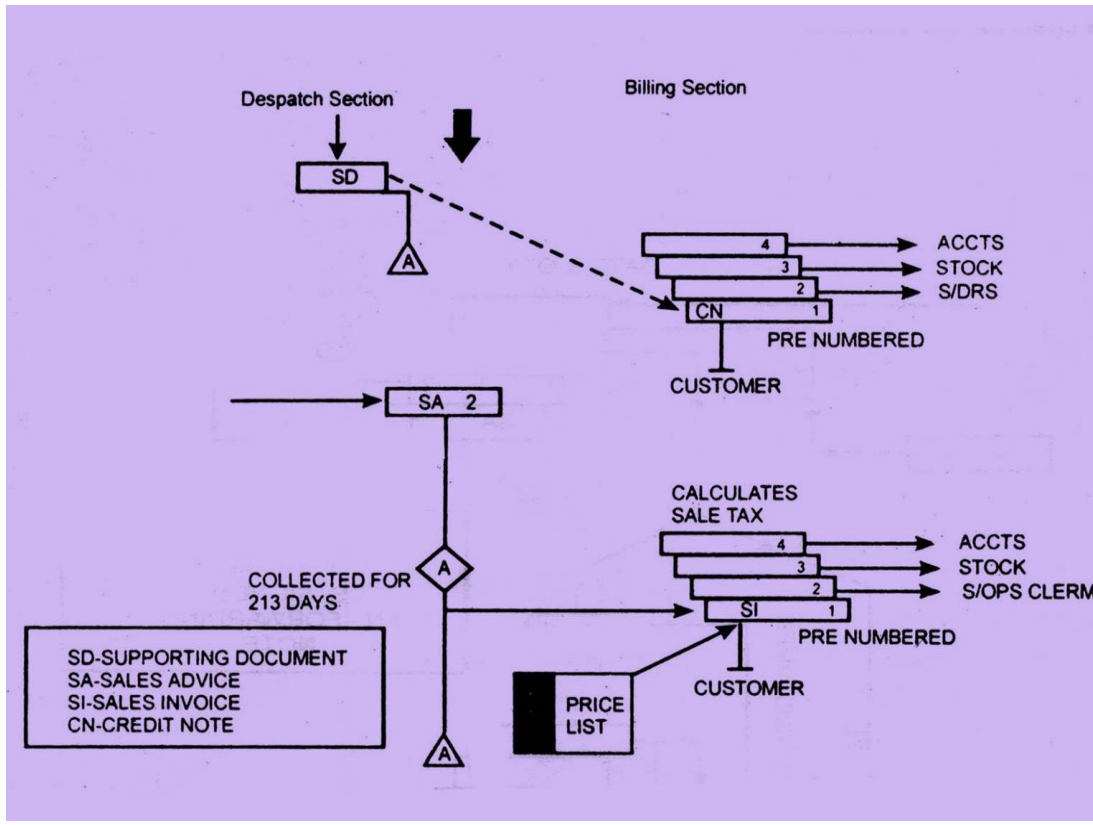
CHART 2

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

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The Flow Chart for this Section is given below -

CHART 3



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

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

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

(i) The advices are sent by salesmen; though prepared on the same sales advice form as is prepared in the section, there is no check that all the advices sent by salesmen have been

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received. This may entail loss of business because of non-receipt of sales advice. (Refer to the flow chart for the Order Receiving Section).

(ii) The raising of sales advises on the basis of telephonic orders, irrespective of the party's standing and record of performance is risky from the business point of view. (Refer to the flow chart for the Order Receiving Section).

(iii) There is no system of prior credit sanction to the parties; in consequence, there may be dispatch of goods to bad credit risks. (Refer to the flow chart for the Dispatch Section).

(iv) There is no check that all the second copies of the sales advices sent by the Dispatch Section have been received by the Billing Section. The possibility of dispatch not being, billed exists, (Refer to the flow chart for the Dispatch as well as the Billing Section.

(v) There is no check in respect of pricing, extension and addition on the invoice or the credit notes. This may result in loss of revenue for wrong pricing or wrong calculation. (Refer to the flow chart for Billing Section).

(vi) It is not clear whether the supporting documents are adequate for authorising the issue of credit notes where there is a need for a greater caution. (Refer to the flow chart for Billing Section).

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

(a) There exists proper numerical control over orders booked (except the case for the salesmen's orders).

(b) There is a permanent and continuous record of the orders booked in the form of order book.

(c) There is a definite basis for raising sales advices.

(d) The order book record is always kept complete by entering the information about the execution of the order and this keeps the information about the pending orders ready at any moment.

(e) Partly executed orders are reviewed from time to time so that as soon as goods are available, the same may be dispatched to customers.

(f) The customer's purchase order and the related sales advice are matched and kept together in the customer's file.

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(g) The sales advices are initialed by the Dispatch Section head as token of his having satisfied himself about the correctness of the entries as regards the quantity dispatched and the date of dispatch.

(h) Record of actual direct delivery is maintained through the copy of the sales advice bearing the customer's, acknowledgement of his having received the goods. Similarly, the record of out station deliveries is kept in the copy of the forwarding note annexed to the sales advice copy.

(i) Documents have as many copies as are necessary for ensuring proper flow and proper control. There is neither wastage through unnecessary copies nor any hold up because of inadequacy of copies.

(j) There are supporting documents for raising invoices and credit notes.

(k) The distribution of invoices and credit notes is such as would enable the recording of billing at the relevant centres independent of each other.

(l) There is control over the number of invoices and credit notes by pre-numbering.

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

7. REPORTING TO CLIENTS ON INTERNAL CONTROL WEAKNESSES

During the course of audit work, the audit may notice material weaknesses in the internal control system. Material weaknesses are defined as absence of adequate controls on flow of transactions that increases the possibility of errors and frauds in the financial statements of the entity.

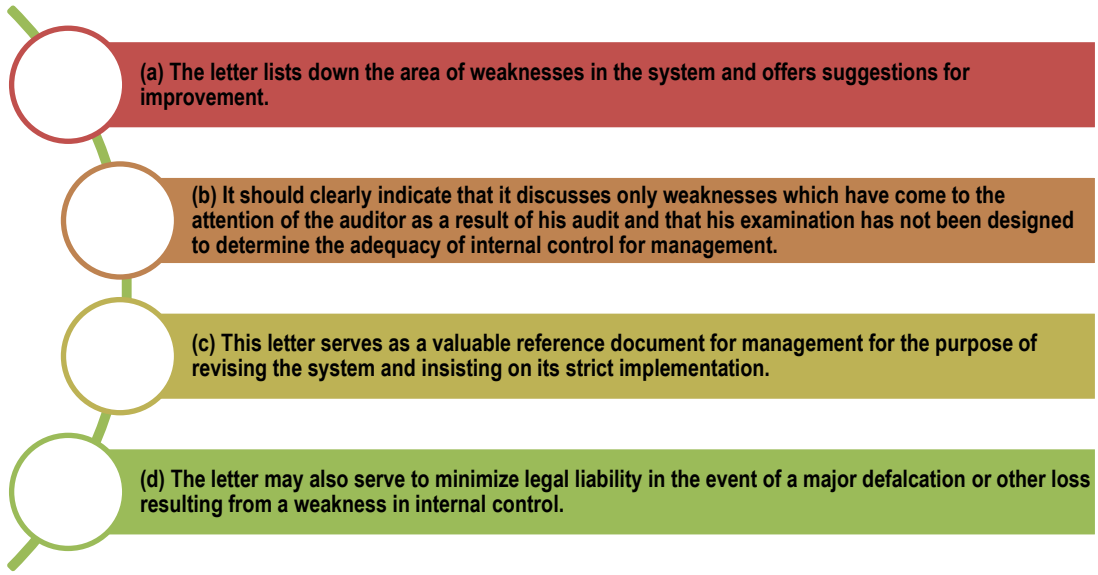


12. In case, if monthly age-wise analysis of trade receivables is not performed then it may result in inadequate provisioning of bad debts for the fiscal year under audit.

The auditor should communicate such material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a

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letter of weakness or management letter. **Important points with regard to such a letter are as follows:**



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

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

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

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

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

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

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

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

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

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

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

(a)	A description of the deficiencies and an explanation of their potential effects; and
(b)	Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (i) The purpose of the audit was for the auditor to express an opinion on the financial statements; (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and

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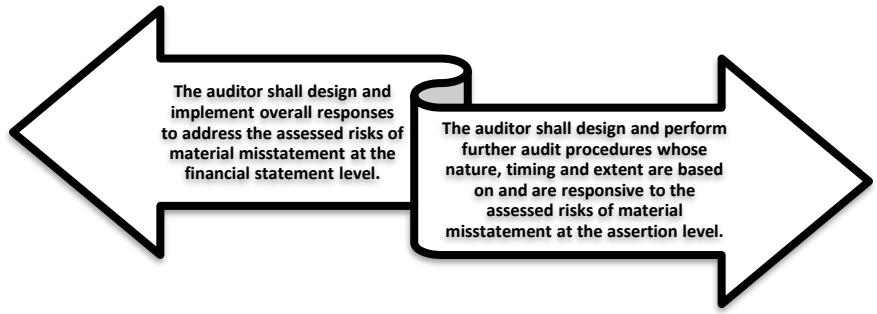
(iii)	The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Based upon risks of material misstatements identified and assessed by the auditor, auditor develops responses to assessed risks.

SA 330, "The Auditor's Responses to Assessed Risks", deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315.

The objective of the auditor in accordance with SA 330 is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

SA 330 states that:



In designing the further audit procedures to be performed, the auditor shall:
(a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including: (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and (ii) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and
(b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

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The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

TEST YOUR UNDERSTANDING 5

CA S is statutory auditor of a listed company. On reviewing internal controls of the company, he is of the view that there can be possible situations where insurance premiums for keeping insurance policies current in respect of various assets of company may have become due and payable but internal control systems established by the company may not be able to capture it.

Elaborate how he should proceed to deal with the above matter.

8. FRAMEWORKS OF INTERNAL CONTROL

Corporate internal controls are part of the governance mechanisms of every organisation and, whether a company adopts a global internal control framework or develops its own, management should always be guided by the need to safeguard business value. There are a number of global internal control frameworks that provide guidance to entities for developing and establishing their internal control systems.

Control should be built and established within the processes through which the company pursues its objectives. It follows that, rather than developing separate risk reporting systems, it would be more appropriate to build early warning mechanisms into existing management information systems. The board of directors or those charged with governance need to consider whether they have enough timely, relevant and reliable reports on progress against business objectives and significant risks.

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Objective: Internal control is fundamental to the successful operation and day-to-day running of a business, and it assists the company in achieving its business objectives. It is wider in scope and encompasses all controls incorporated into the strategic, governance and management process, covering the company's entire range of activities and operations, and not limited to those directly related to financial operations and reporting. There are many internal control frameworks. The objective of this chapter is to give an overview of the common international frameworks.

Guidance Note on Audit of Internal Financial Controls Over Financial Reporting: ICAI has issued a Guidance Note on Audit of Internal Financial Controls Over Financial Reporting which covers aspects such as Scope of reporting on internal financial controls under the Companies Act 2013, essential components of internal controls, Technical Guidance on Audit of Internal Financial Controls, Implementation Guidance on Audit of Internal Financial Controls. The Guidance Note states as below:

"To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the financial reporting framework.

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

Similarly, a benchmark internal control system, based on suitable criteria, is essential to enable the management and auditors to assess and state adequacy of and compliance with the system of internal control. In the Indian context, students are advised to refer Appendix 1 "Internal Control Components" of SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment", as it provides the necessary criteria for internal financial controls over financial reporting for companies.

8.1 International Internal Control Frameworks

An overview of different internal control frameworks followed internationally are given below:

A. Internal Control - Integrated Framework issued by Committee of the Sponsoring Organisations of the Treadway Commission (COSO Framework)

COSO's Internal Control – Integrated Framework was introduced in 1992 as guidance on how to establish better controls so companies can achieve their objectives. COSO categorizes entity-level

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objectives into operations, financial reporting, and compliance. The framework includes more than 17 basic principles representing the fundamental concepts associated with its five components: control environment, risk assessment, control activities, information and communication, and monitoring. Some of the principles include key elements for compliance, such as integrity and ethical values, authorities and responsibilities, policies and procedures, and reporting deficiencies.

However, the Framework clarifies the requirements for effective internal control. This was largely done through the articulation of the 17 principles, which are relevant to every entity and must be present and functioning in order to have an effective system of internal control. Here are the tiles of the 17 internal control principles by internal control component as presented in COSO's framework:

Control Environment	*Risk Assessment*	*Control Activities*	*Information and Communication*	*Monitoring*
✓ Demonstrates commitment to integrity and ethical values ✓ Exercises oversight responsibility ✓ Establishes structure, authority, and responsibility ✓ Demonstrates commitment to competence ✓ Enforces accountability	✓ Specifies suitable objectives ✓ Identifies and analyses risk ✓ Assesses fraud risk ✓ Identifies and analyses significant change	✓ Selects and develops control activities ✓ Selects and develops general controls over technology ✓ Deploys through policies and procedures	✓ Uses relevant information ✓ Communicates internally ✓ Communicates externally	✓ Conducts ongoing and/or separate evaluations ✓ Evaluates and communicate deficiencies

The COSO Framework is designed to be used by organizations to assess the effectiveness of the system of internal control to achieve objectives as determined by management. The Framework lists three categories of objectives as below:

- ***Operations Objectives*** – related to the effectiveness and efficiency of the entity's operations, including operational and financial performance goals, and safeguarding assets against loss.

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- ***Reporting Objectives*** – related to internal and external financial and non-financial reporting to stakeholders, which would encompass reliability, timeliness, transparency, or other terms as established by regulators, standard setters, or the entity's policies.
- ***Compliance objectives*** – In the Framework, the compliance objective was described as "relating to the entity's compliance with applicable laws and regulations." The Framework considers the increased demands and complexities in laws, regulations, and accounting standards.

Limitations of Internal Control: The Framework acknowledges that there are limitations related to a system of internal control. For example, certain events or conditions are beyond an organization's control, and no system of internal control will always do what it was designed to do. Controls are performed by people and are subject to human error, uncertainties inherent in judgment, management override, and their circumvention due to collusion. An effective system of internal control recognizes their inherent limitations and addresses ways to minimize these risks by the design, implementation, and conduct of the system of internal control. However, an effective system will not eliminate these risks. An effective system of internal control provides reasonable assurance, not absolute assurance, that the entity will achieve its defined operating, reporting, and compliance objectives.

B. Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants (CoCo)

CoCo was introduced with the objective of improving organizational performance and decision-making with better controls, risk management, and corporate governance.

The **Criteria of Control (CoCo)** framework was developed by the Canadian Institute of Chartered Accountants with the objective of improving organisational performance and decision making with better controls, risk management, and corporate governance. The framework includes 20 criteria for effective control in four areas of an organization: purpose (direction), commitment (identity and values), capability (competence), and monitoring and learning (evolution).

The framework emphasizes that control involves the entire organization but begins on an individual level, with the employee.

The CoCo framework outlines criteria for effective control in the following four areas:

- Purpose
- Commitment

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- Capability
- Monitoring and Learning

In order to assess whether controls exist and are operating effectively, each criterion would be examined to identify the controls that are in place to address them.

C. Control Objectives for Information and Related Technology (COBIT)

COBIT stands for Control Objectives for Information and Related Technology. It is a framework created by the ISACA (Information Systems Audit and Control Association) for IT governance and management. COBIT has 34 high-level processes that cover 210 control objectives categorized in four domains: planning and organization, acquisition and implementation, delivery and support, and monitoring and evaluation. It is designed as a supportive tool for managers and allows bridging the crucial gap between technical issues, business risks and control requirements.

Business managers are equipped with a model to deliver value to the organization and practice better risk management practices associated with the IT processes. It is a control model that guarantees the integrity of the information system. Today, COBIT is used globally by all managers who are responsible for the IT business processes. It is a thoroughly recognized guideline that can be applied to any organization across industries. Overall, COBIT ensures quality, control and reliability of information systems in organization, which is also the most important aspect of every modern business.

This framework guides an organization on how to use IT resources (i.e., applications, information, infrastructure, and people) to manage IT domains, processes, and activities to respond to business requirements, which include compliance, effectiveness, efficiency, confidentiality, integrity, availability, and reliability. Well-governed IT practices can assist businesses in complying with laws, regulations, and contractual arrangements.

D. Internal Control: Guidance for Directors on the Combined Code, published by the Institute of Chartered Accountants in England & Wales (known as the Turnbull Report)

When the Combined Code of the Committee on Corporate Governance (the Code) was published, the Institute of Chartered Accountants in England & Wales agreed with the London Stock Exchange that it would provide guidance to assist listed companies to implement the requirements in the Code relating to internal control. The key principles of the Code are enunciated as below:

- The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

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- The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.
- Companies which do not have an internal audit function should from time to time review the need for one.

The guidance requires directors to exercise judgement in reviewing how the company has implemented the requirements of the Code relating to internal control and reporting to shareholders thereon. The guidance is based on the adoption by a company's board of a risk-based approach to establishing a sound system of internal control and reviewing its effectiveness. This should be incorporated by the company within its normal management and governance processes. It should not be treated as a separate exercise undertaken to meet regulatory requirements.

E. Sarbanes-Oxley Section 404

Section 404 of Sarbanes-Oxley Act (Sarbanes-Oxley Act Section 404) of United States of America mandates that all publicly-traded companies must establish internal controls and procedures for financial reporting and must document, test and maintain those controls and procedures to ensure their effectiveness. The purpose of SOX is to reduce the possibilities of corporate fraud by increasing the stringency of procedures and requirements for financial reporting. The Sarbanes Oxley Act, has revamped federal regulations pertaining to publicly traded companies' corporate governance and reporting obligations. It was followed up with constitution of PCAOB (Public Company Accounting Oversight Board). It regulates the audits of public companies and SEC-registered brokers and dealers in order to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

The SEC rules and PCAOB standard require that:

- Management perform a formal assessment of its controls over financial reporting including tests that confirm the design and operating effectiveness of the controls.
- Management include in its annual report an assessment of ICFR.
- The external auditors provide two opinions as part of a single integrated audit of the company:
  - An independent opinion on the effectiveness of the system of ICFR.
  - The traditional opinion on the financial statements.

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Key Takeaways

- Audit risk is the risk of expressing an inappropriate audit opinion on financial statements that are materially misstated. The components of audit risk include inherent risk, control risk and detection risk. Audit Risk (AR) can be expressed as a product of Inherent Risk (IR), Control Risk (CR) and Detection Risk (DR), i.e. AR = IR x CR x DR
- Auditors are required to assess the risks of material misstatement at two levels. The first is at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions and second one relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level.
- A set of internally generated policies and procedures adopted by the management of an enterprise is a prerequisite for an organisations efficient and effective performance. It is thus, a primary responsibility of every management to create and maintain an adequate system of internal control appropriate to the size and nature of the business entity.
- Internal control is the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.
- Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives.
- Components of internal control include control environment, entity's risk assessment process, the information system, including the related business processes, relevant to financial reporting, and communication, control activities and monitoring of controls.
- Review of internal control system enables auditor to formulate his opinion as to the reliance he may place on the system itself i.e. whether the system is such as would enable the management to produce a true and fair set of financial statements; and to locate the areas of weakness in the system so that the audit programme and the nature, timing and extent of substantive and compliance audit procedures can be adjusted to meet the situation.
- In accordance with SA 265, it is auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the

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auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

- Based upon risks of material misstatements identified and assessed by the auditor, auditor develops responses to assessed risks.SA 330 deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315.
- Corporate internal controls are part of the governance mechanisms of every organisation and, whether a company adopts a global internal control framework or develops its own, management should always be guided by the need to safeguard business value. There are a number of global internal control frameworks that provide guidance to entities for developing and establishing their internal control systems.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM: SCAN ME !

Note : Content of SA 315-Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment and SA 320-Materiality in Planning and Performing an Audit is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *CA B was appointed as the auditor of ABC Limited for the financial year 2023-24. During the course of planning for the audit, CA B intends to apply the concept of materiality for the financial statements as a whole. Please guide him with respect to the factors that may affect the identification of an appropriate benchmark for this purpose.*

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What benchmark should be adopted by CA B, if ABC Limited is engaged in:

(i) the manufacture and sale of air conditioners and is having regular profits.

(ii) the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic.

2. *What are the components of an internal control framework?*

3. *During the audit, auditor noticed material weaknesses in the internal control system, and he wishes to communicate the same to the management. You are required to elucidate the important points the auditor should keep in mind while drafting the letter of weaknesses in internal control system.*

4. *Explain briefly the Flow Chart technique for evaluation of the Internal Control system.*

5. *As auditor of Z Ltd., you would like to limit your examination of account balance tests. What are the control objectives you would like the accounting control system to achieve to suit your purpose?*

6. *New Life Hospital is a multi-speciality hospital which has been facing a lot of pilferage and troubles regarding their inventory maintenance and control. On investigation into the matter it was found that the person in charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. According to you, which basic system of control has been violated? Also list down the other general conditions pertaining to such system which needs to be maintained and checked by the management.*

7. *Compute the overall Audit Risk if looking to the nature of business there are chances that 40% bills of services provided would be defalcated, inquiring on the same matter management has assured that internal control can prevent such defalcation to 75%. At his part the Auditor assesses that the procedure he could apply in the remaining time to complete Audit gives him satisfaction level of detection of frauds & error to an extent of 60%. Analyse the Risk of Material Misstatement and find out the overall Audit Risk.*

8. *ST Ltd is a growing company and currently engaged in the business of manufacturing of tiles. The company is planning to expand and diversify its operations. The management has increased the focus on the internal controls to ensure better governance. The management had a discussion with the statutory auditors to ensure the steps required to be taken so that the statutory audit is risk based and focused on areas of greatest risk to the achievement of*

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the company's objectives. Please advise the management and the auditor on the steps that should be taken for the same.

9. *Y Co. Ltd. has five entertainment centers to provide recreational facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kilometers. Collections are made in cash. Specify the adequate system towards collection of money.*

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

11. *Your engagement team is seeking advice from you as engagement partner regarding steps for risk identification. Elaborate.*

12. *BSF Limited is engaged in the business of trading leather goods. You are the internal auditor of the company for the year 2023-24. In order to review internal controls of the Sales Department of the company, you visited the Department and noticed the work division as follows:*

    (1) An officer was handling the sales ledger and cash receipts.

    (2) Another official was handling dispatch of goods and issuance of Delivery challans.

    (3) One more officer was there to handle customer/ debtor accounts and issue of receipts.

    As an internal auditor, you are required to briefly discuss the general condition pertaining to the internal check prevalent in internal control system. Do you think that there was proper division of work in BSF Limited? If not, why?

13. ***While assessing the impact of uncorrected misstatements in the audit of MINI Builders Private Limited, Mr. Gautam encountered a significant issue related to the calculation of materiality on revenue. The initial materiality calculation was based on estimated figures provided by the management. Management, to estimate full-year revenue, extrapolated the sales for 11 months to arrive at a figure for 12 months. However, given the nature of MINI Builders as a company in the construction sector, where monthly sales exhibit substantial variations, a unique challenge emerged.***

    The actual sales for the last month deviated significantly from the estimated sales due to an unexpected slowdown in project completions. As a result, the last month's actual sales represented only 30% of the estimated sales. Now, Mr. Gautam is confronted with a dilemma regarding the appropriate approach to evaluate

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uncorrected misstatements using the previously calculated materiality. Kindly Guide Mr. Gautam in the light of relevant Standards on Auditing.

14. ***Deepti & Co., Chartered Accountants, during the audit of Magma Ltd. found that certain machinery had been imported for the production of a new product. Although the auditors have applied the concept of materiality to the financial statements as a whole, they now want to re-evaluate the materiality concept for the said transaction involving foreign exchange. Give your views in this regard?***

15. ***AMRO Ltd. is a manufacturing and trading Company of leather goods since last 10 years. You are the internal auditor of the company for the year 2023-24. In order to review internal controls of the company, you visited the departments and noticed:***

    (1) The head of procurement, Mr. Amit, has complete control over purchasing, receiving goods, and approving payments to suppliers. His actions are not reviewed by any other person in the company.

    (2) The company's staff has been working in the same roles for over five years without any rotation. The finance manager, Mr. Sachin, in particular, has never had his duties rotated since joining the company.

    (3) The store manager, Mr. Gupta, who is responsible for maintaining the inventory, also keeps the inventory records.

    (a) Briefly discuss the general conditions pertaining to the internal check system to be ensure by you as an auditor.

    (b) Do you think that general conditions pertaining to the internal check system are violated in the given situation?

Answers to Test your Understanding Question

1. Evaluation of internal controls influences auditor's assessment of risks of material misstatement. Risks of material misstatement also consists of control risk.

In the given situation of statutory audit of a Divisional office of a public sector insurance company, it is noticed that procedure relating to delegation of powers has not been followed and surveyor appointments have been made in violation of laid down procedures. It is a serious violation and shows that controls are not operating effectively as laid down by company management.

Such deviations from established controls may lead auditor to conclude that control risk needs to be revised. Revision of control risk assessment is likely to lead to revision in risks of material misstatement. It may also result in modification of nature, timing and extent of planned substantive procedures.

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2. For assessing audit risk, auditor shall consider all components of audit risk. The said NGO is working in a political-cum-social field which can make its activities inherently risky. Crowd funding donations may have to be seen in relation to the constitution of NGO which may make these risky. Since the NGO is in receipt of foreign funds, it may make transactions inherently risky. The credibility and integrity of persons behind NGO is important. Shady NGOs can be involved in money laundering activities and may be involved in mis utilizing funds from donors. Since last year's accounts were unaudited, it also increases the inherent risk due to the probable effect of misstatements, if any, of last year. Non-compliance with strict laws has the potential to make activities of NGO inherently risky.

Since NGO has received substantial donations in the current year and its activities were on a relatively small scale during last year, formal controls may not be in place. Lack of formal controls may lead to non-compliance with laws. Non-compliance with FCRA can have serious consequences including cancelling such certificate of NGO. Therefore, control risk could be high.

Further, audit for NGO has been accepted for the first time. There may be a lack of understanding of activities of NGO. It may lead to higher detection risk due to inappropriate sampling procedures or faulty application of audit procedures.

3. Internal audit involves continuous and critical appraisal of functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity including its strategic risk management and internal control system. Internal audit also involves evaluation of internal control to provide assurance to management regarding design, implementation and operating effectiveness of control.

In the given situation, the information system requires booking of purchases in purchase ledger and stock records from date of invoice. Such a control system is likely to present a distorted picture of stocks of the company. It would show stocks of raw material as received whereas these goods could be in transit. Therefore, the design of the control itself is faulty, which allows booking from date of purchase invoice only. Further, such a system can have implications with respect to GST laws.

The internal auditor should report on the above matter asking management for corrective action.

4. The above referred component of internal control is "Control activities". Control activities that may be relevant to an audit include policies and procedures that pertain to "performance reviews".

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Such control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.

The control activities pertaining to analysis of budgeted target of sales with respect to actual performance, fixing of responsibilities and taking timely corrective action falls in nature of performance reviews. Such performance reviews are part of control activities which is a component of internal control.

5. A deficiency in internal control exists when:

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

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

In the above situation, there is a possibility that internal control systems established by the company may not be able to capture insurance premiums which may have become due and payable. It is a significant deficiency as failure to keep insurance policies current would render assets of the company uninsured. It may lead to losses for the company in case of any eventuality.

Further, in accordance with SA 265, the significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may, therefore, exist even though the auditor has not identified misstatements during the audit.

The susceptibility to loss of an asset is a factor in determining whether a deficiency constitutes significant deficiency in internal control.

The auditor shall communicate in writing significant deficiency in internal control to those charged with governance and include in the written communication of significant deficiencies in internal control: -

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

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

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Answers to Theoretical Questions

1. **Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole:** As per SA 320, determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

   Factors that may affect the identification of an appropriate benchmark include the following:

   - The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
   - Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
   - The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
   - The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
   - The relative volatility of the benchmark.

   Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

   In case if ABC Limited is engaged in manufacture and sale of air conditioner, and is having regular profits: CA B, the auditor may consider profit before tax /Earnings.

   In case ABC Limited is engaged in the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic: CA B, the auditor may consider Revenue or Gross Profit as benchmarking.

   Alternatively, CA B, the auditor may consider the criteria relevant for audit of the entities doing public utility programs/ projects, Total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular

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program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

2. There are five components of an internal control framework. They are as follows:

- Control Environment;
- Risk Assessment;
- Information & Communication;
- Monitoring;
- Control Activities.

3. **Important Points to be kept in Mind While Drafting Letter of Weakness:** As per SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", the auditor shall include in the written communication of significant deficiencies in internal control:

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

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

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

(1) The letter lists down the area of weaknesses in the system and offers suggestions for improvement.

(2) It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.

(3) This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.

(4) The letter may also serve to minimize legal liability in the event of a major defalcation or other loss resulting from a weakness in internal control.

4. Refer Para 6.1.3

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5. Basic Accounting Control Objectives: The basic accounting control objectives which are sought to be achieved by any accounting control system are -

(i) Whether all transactions are recorded;

(ii) Whether recorded transactions are real;

(iii) Whether all recorded transactions are properly valued;

(iv) Whether all transactions are recorded timely;

(v) Whether all transactions are properly posted;

(vi) Whether all transactions are properly classified and disclosed;

(vii) Whether all transactions are properly summarized.

6. **Basic system of Control:** Internal Checks and Internal Audit are important constituents of Accounting Controls. Internal check system implies organization of the overall system of book-keeping and arrangement of Staff duties in such a way that no one person can carry through a transaction and record every aspect thereof.

In the given case of New Life Hospital, the person-in-charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. Thus, one of the basic system of control i.e. internal check which includes segregation of duties or maker and checker has been violated where transaction processing are allocated to different persons in such a manner that no one person can carry through the completion of a transaction from start to finish or the work of one person is made complimentary to the work of another person.

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

(i) No single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.

(ii) Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time.

(iii) Every member of the staff should be encouraged to go on leave at least once a year.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

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(v) There should exist an accounting control in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.

(vi) Mechanical devices should be used, wherever practicable, to prevent loss or misappropriation of cash.

(vii) Budgetary control should be exercised and wide deviations observed should be reconciled.

(viii) For inventory taking, at the close of the year, trading activities should, if possible be suspended, and it should be done by staff belonging to several sections of the organization.

(ix) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which those are actually exercised should be reviewed periodically.

(x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

7. According to SA-200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the Audit Risk is a risk that Auditor will issue an inappropriate opinion while Financial Statements are materially misstated.

Audit Risk has two components: Risk of material Misstatement and Detection Risk. The relationship can be defined as follows.

Audit Risk = Risk of Material Misstatement X Detection Risk

Risk of Material Misstatement: - Risk of Material Misstatement is anticipated risk that a material Misstatement may exist in Financial Statement before start of the Audit. It has two components Inherent risk and Control risk. The relationship can be defined as

Risk of Material Misstatement = Inherent risk X control risk

Inherent risk: It is a susceptibility of an assertion about account balance; class of transaction, disclosure towards misstatements which may be either individually or collectively with other Misstatement becomes material before considering any related internal control which is 40% in the given case.

Control risk: It is a risk that there may be chances of material Misstatement even if there is a control applied by the management and it has prevented defalcation to 75%.

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Hence, control risk is 25% (100%-75%)

Risk of Material Misstatement: Inherent risk X Control risk i.e., 40% X 25 % = 10%

Chances of Material Misstatement are reduced to 10% by the internal control applied by management.

Detection risk: It is a risk that a material misstatement remained undetected even if all audit procedures applied, Detection Risk is 100-60=40%

In the given case, overall Audit Risk can be reduced up to 4% as follows:

Audit Risk: Risk of Material Misstatement X Detection Risk = 10X 40% = 4%

8. Refer Para 2.2

9. **Control System over Selling and Collection of Tickets:** In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted -

(i) **Printing of tickets:** Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.

(ii) **Ticket sales:** The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.

(iii) **Daily cash reconciliation:** Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.

(iv) **Daily banking:** Each day's collection should be deposited in the bank on the next working day of the bank. Till that time, the cash should be in the custody of properly authorized person preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.

(v) **Entrance ticket:** Entrance tickets should be cancelled at the entrance gate when the public enters the centre.

(vi) **Advance booking:** If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.

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(vii) **Discounts and free pass:** The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.

(viii) **Surprise checks:** Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

10. Communication and enforcement of integrity and ethical values: Refer Para 4.1.

11. Refer Para 1.3.

12. The general condition pertaining to the internal check system may be summarized as under: refer para 4.5.

In the given scenario, Company has not done proper division of work as:

(i) the receipts of cash should not be handled by the official handling sales ledger and

(ii) delivery challans should be verified by an authorised official other than the officer handling despatch of goods.

13. As per SA 450, "Evaluation of Misstatements Identified during the Audit", the auditor is required to reassess materiality, in accordance with SA 320, "Materiality in Planning and Performing an Audit", before evaluating the impact of uncorrected misstatements. This reassessment is crucial to confirm the ongoing appropriateness of materiality in light of the entity's actual financial results.

The determination of materiality under SA 320 often relies on estimates of the entity's financial results, given that the actual results may not be known during the early stages of the audit. Therefore, before the auditor proceeds to assess the effect of uncorrected misstatements, it becomes necessary to adjust the materiality calculated under SA 320 based on the now available actual financial results.

SA 320 outlines that, as the audit progresses, materiality may be revised for the financial statements as a whole or for specific classes of transactions, account balances, or disclosures. This revision is prompted by the auditor's awareness of information that would have led to a different initial determination. Typically, significant revisions occur before the evaluation of uncorrected misstatements. However, if the reassessment of materiality under SA 320 results in a lower amount, the auditor must reconsider performance materiality and the appropriateness of the audit procedures' nature, timing, and extent. This is crucial for obtaining sufficient and appropriate audit evidence on which to base the audit opinion.

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In the present case involving MINI Builders Private Limited, it has been identified that the materiality calculated at the beginning of the audit for revenue was based on estimates provided by the management. The management extrapolated sales for the full year using the actual amount of 11 months, but since the company experiences significant monthly variations in sales, the actual sales for the last month were only 30% of the estimated figure. This discrepancy arose due to an unexpected slowdown in project completion.

In this audit scenario, Mr. Gautam, the auditor, must review and reassess the materiality initially determined under SA 320 to ensure its continued validity in light of the actual financial results. If the re-assessed materiality is lower than the previously calculated amount, Mr. Gautam must reconsider performance materiality and the appropriateness of the nature, timing, and extent of further audit procedures. This meticulous approach is essential to gather sufficient and appropriate audit evidence, enabling Mr. Gautam to form an independent and objective opinion on the financial statements of MINI Builders Private Limited.

14. *As per SA 320, "Materiality in Planning and Performing an Audit", when establishing the overall audit strategy, the auditor shall determine materiality for the financial statement as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.*

The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

If the auditor concludes a lower materiality for the same, he shall determine whether it is necessary to revise performance materiality and whether the nature, timing and extent of the further audit procedures remain appropriate.

In the given case, Deepti & Co., as an auditor has applied the concept of materiality for the financial statements as a whole. But they want to re-evaluate the materiality

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concept on the basis of additional information of import of machinery for production of new product which draws attention to a particular aspect of the company's business.

Thus, Deepti & Co. can re-evaluate the materiality concepts after considering the necessity of such revision.

15. (a) Internal Check System: The general condition pertaining to the internal check system may be summarized as under:

(i) no single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.

(ii) Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time.

(iii) Every member of the staff should be encouraged to go on leave at least once a year.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

(v) There should exist an accounting control in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.

(vi) Mechanical devices should be used, wherever practicable, to prevent loss or misappropriation of cash.

(vii) Budgetary control should be exercised, and wide deviations observed should be reconciled.

(viii) For inventory taking, at the close of the year, trading activities should, if possible be suspended, and it should be done by staff belonging to several sections of the organization.

(ix) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which those are actually exercised should be reviewed periodically.

(x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

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(b) Yes, in the given situation general conditions pertaining to the internal check system are violated as follows:

(1) The head of procurement, Mr. Amit, having complete control over the procurement process without oversight violates the principle that no single person should control any important aspect of the business operation.

(2) The lack of staff rotation for over five years violates the principle that staff duties should be rotated periodically to prevent any single person from performing the same function for too long.

(3) Allowing Mr. Gupta, the store manager, to maintain inventory records while also having custody of the inventory violates the principle that those with physical custody of assets should not have access to accounting records.

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CHAPTER 5

AUDIT EVIDENCE



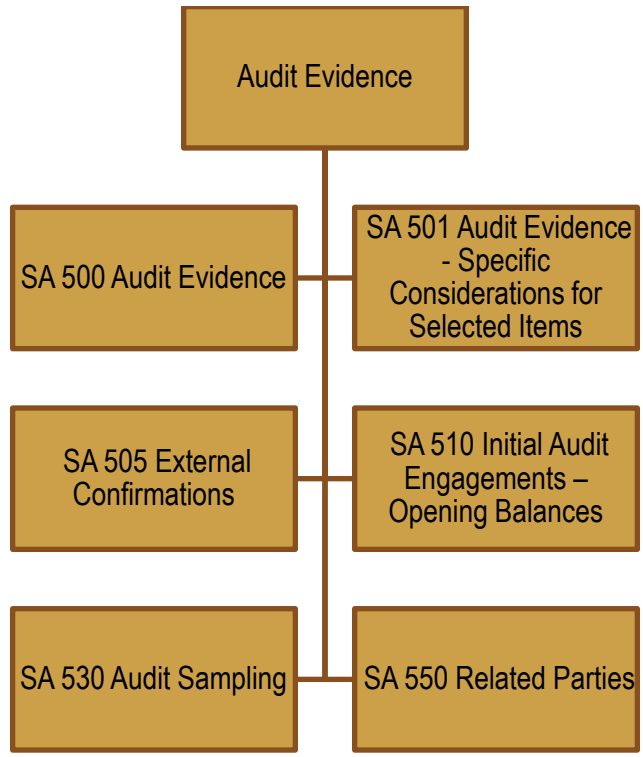
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Refreshen up your knowledge about procedures relating to Audit Evidence.
- Glance through relevant SAs-SA 500, SA 501, SA 505, SA 510, SA 530 and SA 550 pictorially.
- Gain application-based knowledge of above SAs.
- Understand the concepts through use of analytical examples and case studies.
- Gain knowledge about varied practical situations for an auditor while performing such procedures.

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CHAPTER OVERVIEW



CA. Kartik is intrinsically efficient and has an inherent dislike for wasting time on frivolous things. He wants to do everything perfect- spick and span- and in a cost- effective manner. Adopting the same approach, in the course of his professional work as an auditor, he is very particular in completing work quickly in a time bound manner.

During one such audit of a company's accounts, he chose to select some specific items for performing "tests of details" according to his judgment. Like, he decided to verify sales transactions above the threshold amount of ₹ 25 lacs. Fresh additions to "Property, Plant and Equipment" above the threshold of the same amount were selected by him for detailed verification.

He also grew suspicious about certain sales transactions aggregating to ₹ 50 lacs. Such transactions were at fag end of the year, and goods moved out from the company's premises were purportedly sent through non-motorised conveyance without accompanying e-way bills to a single customer over a span of few days. It was agreed to send an external confirmation request to this customer only. Besides, it was decided to go through all related party transactions in a detailed manner without exception to dig out any material misstatement.

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Litigation claims involving the company were considered a misstatement prone area and came for detailed examination on his radar. Such a testing approach, he thought, would be efficient and cost-effective for obtaining audit evidence.

Can above approach followed by auditor be construed as "audit sampling"? What does it signify and to what kind of risk such an approach is subject to? Such a testing approach to obtain audit evidence relates to "selective examination of specific items" from class of transactions and account balances. While "selective examination of specific items" as a testing means to obtain audit evidence could be an efficient way of obtaining audit evidence, it does not constitute audit sampling.

The results of audit procedures to items selected in this way cannot be projected to the entire population. "Selective examination of specific items" does not provide audit evidence concerning the remainder of the population. Such an approach is subject to non-sampling risk. It is the risk of an auditor reaching an erroneous conclusion due to inappropriate audit procedures, misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

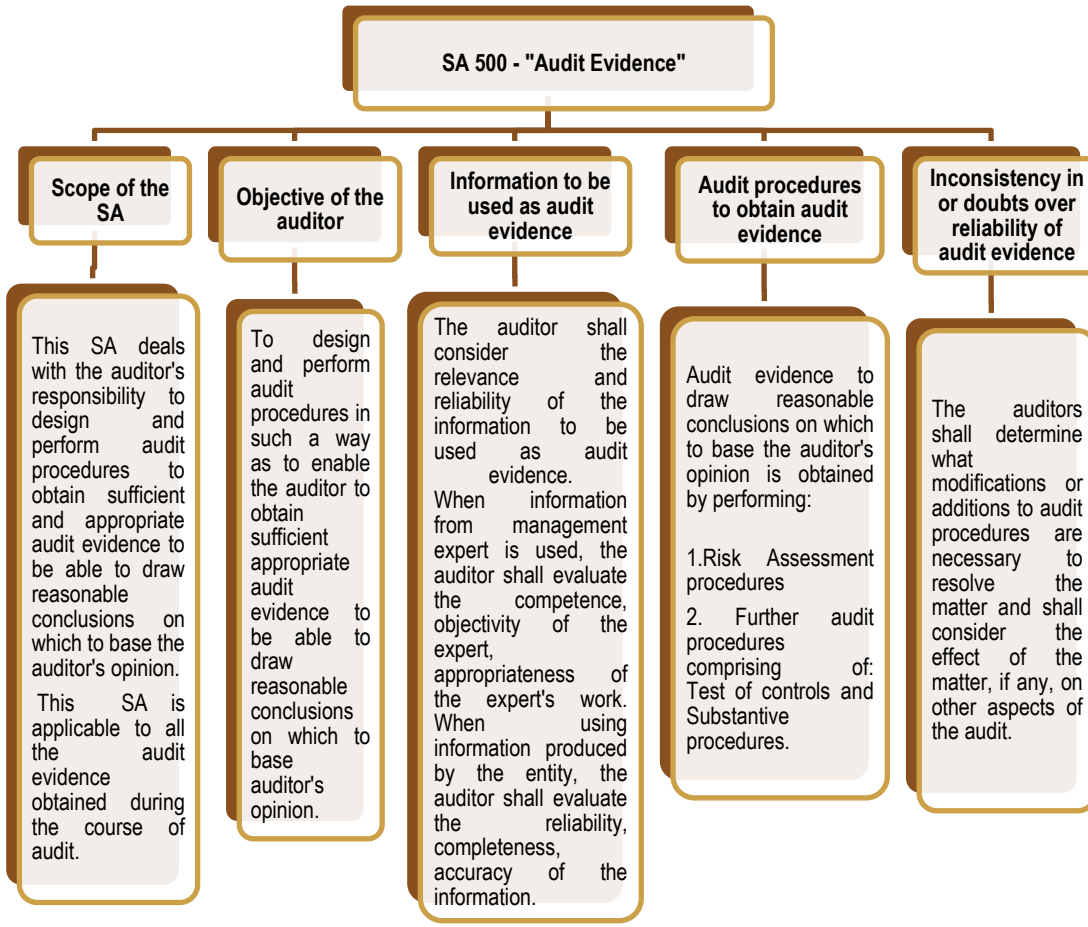
Whereas "audit sampling" refers to the application of audit procedures to less than 100% of items within a population relevant under the audit, such that all the items in the population have an equal chance of selection. Being subject to sampling risk, testing on the basis of samples may also lead to erroneous conclusions. It can be due to the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Such a risk is always there in audit sampling!

1. SA 500 AUDIT EVIDENCE

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

Audit evidence is the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

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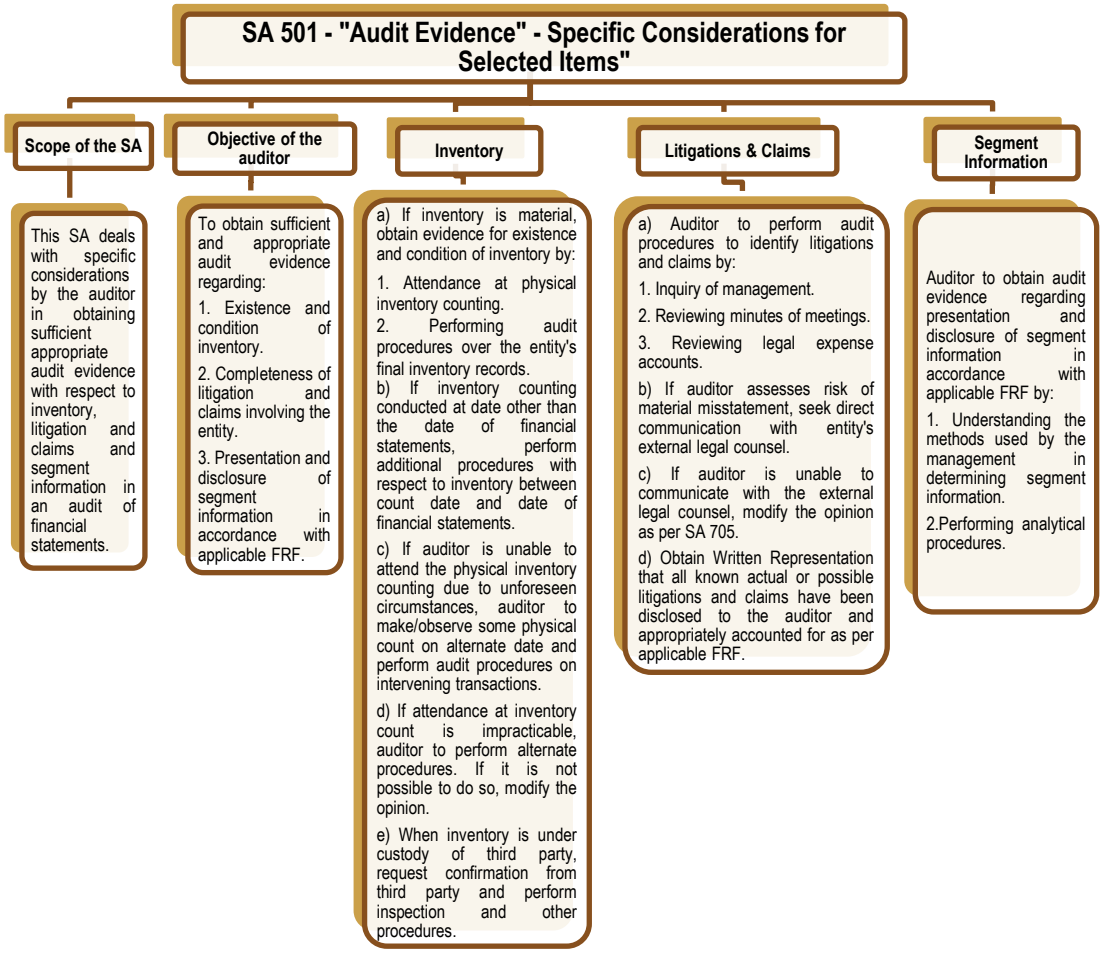
TEST YOUR UNDERSTANDING 1

The auditor of BBNS Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years as against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age to 65 years. Comment.

2. SA 501 AUDIT EVIDENCE - SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

SA 501 deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence with respect to certain aspects of **inventory, litigations and claims involving the entity, and segment information** in an audit of financial statements.

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TEST YOUR UNDERSTANDING 2

CA Prabhjot has planned to observe the physical count of inventories at the plant of a company located in the remote area in the state of Uttarakhand, as part of a statutory audit exercise, few days before completion of the financial year 2023-24. He already informed his intention to management that he is planning to visit the plant site on 29th March 2024. He plans to inspect inventories, observe the counting process and perform test counts among other matters.

The management has made all the necessary arrangements to facilitate the above exercise. However, an agitation in Himalayan hills started on 28th March 2024 for the announcement of a strict law regarding the conversion of agricultural land for commercial use. Many civil society

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groups are participating in the agitation. NH-7 leading to the plant site is blocked by protestors. The plant is not accessible through any other mode. The blockade is lifted one month after the state government announced the formation of a committee to look into protestors' demands.

Does the above case highlight a situation of "impracticability of attendance" at inventory counting in terms of requirements of SA 501?

How should the auditor proceed in the above situation?

TEST YOUR UNDERSTANDING 3

On reviewing legal expenses account of Zed Ltd., CA. Sunitha, auditor of company, finds that legal fees amounting to ₹ 10 lac was paid to B. George, a reputed lawyer, during the year 2023-24. On inquiry with management regarding the purpose of such expenditure, evasive reply was received from management stating that a lot of work is performed by the said lawyer on behalf of the company. However, no specific details were provided.

She finds it proper to correspond directly with the lawyer. She obtains the address and mail id of the lawyer from his professional services bill. She shoots off an inquiry letter asking for the nature and status of litigation claims against the company on her letterhead.

Is her approach proper? Irrespective of the merits of the approach followed by her, what is she trying to achieve by corresponding with the lawyer of the company?

TEST YOUR UNDERSTANDING 4

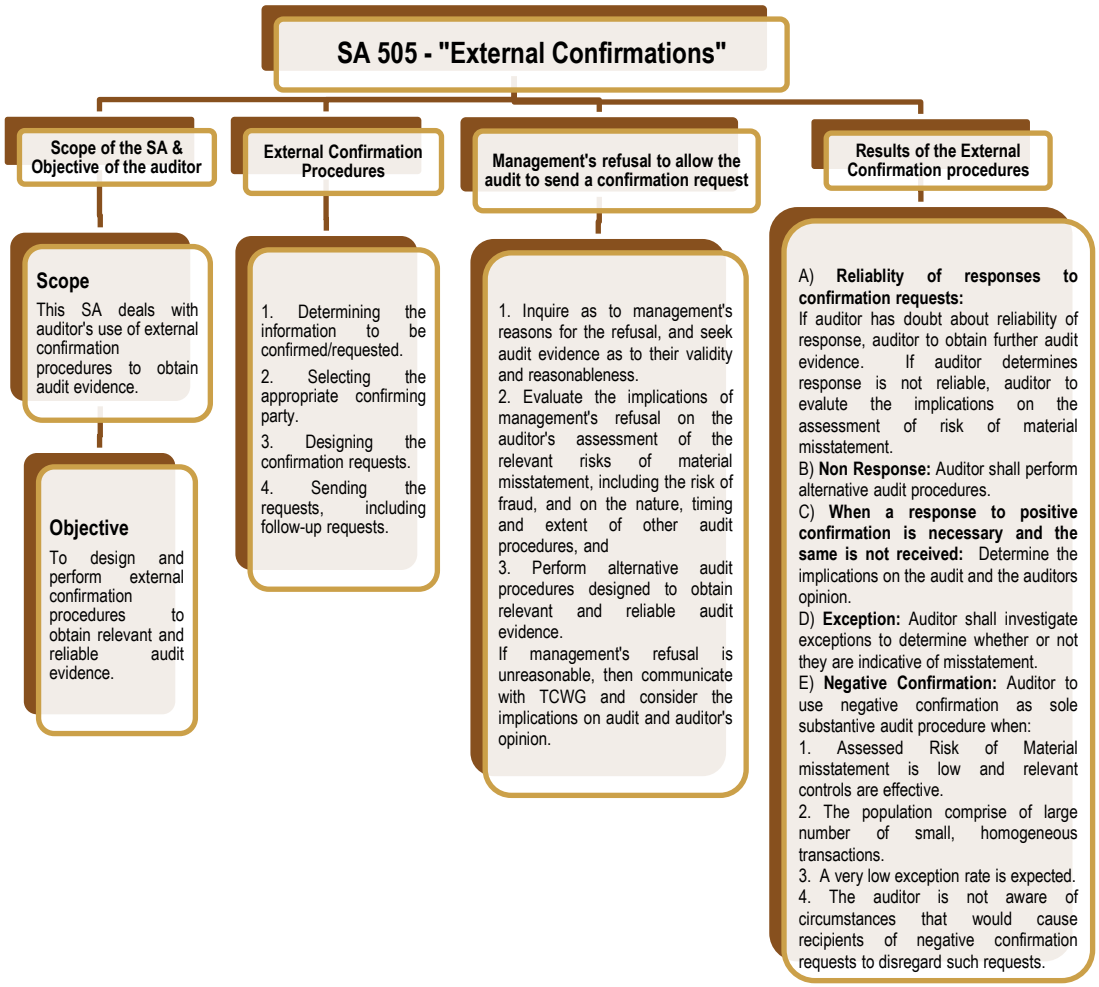
During the audit of TS Ltd., CA Tanmaya finds that substantial inventories of the company consisting of mast lighting poles remain with "Super Industries" for certain finishing works. While planning audit procedures, he had planned about seeking confirmation from "Super Industries" regarding existence and condition of such mast lighting poles belonging to TS Ltd. lying with them as on 31st March, 2024.

However, the premises of "Super Industries" were raided by DGGI officials (Director General of GST Intelligence) in connection with the busting of a fake billing scam. The proprietor of the firm was arrested in November 2023 and came out on bail in the month of March 2024. The details of the proprietor and his firm were flashed prominently in local newspapers of the city where company is located. CA. Tanmaya also belongs to the same place. Discuss how he should proceed in the above matter as auditor of TS Ltd.

3. SA 505 EXTERNAL CONFIRMATIONS

SA 505 deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 500. It is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

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TEST YOUR UNDERSTANDING 5

As auditor of Groom Limited, you have sent positive confirmation requests to 30 creditors of the company in March 2024. All the creditors in the informal sector are small concerns. You selected to send positive confirmation requests to all the above parties at their business addresses stated on respective bills after discussing the matter with the CFO of the company. The CFO is cooperative and does not raise any hassles in the matter.

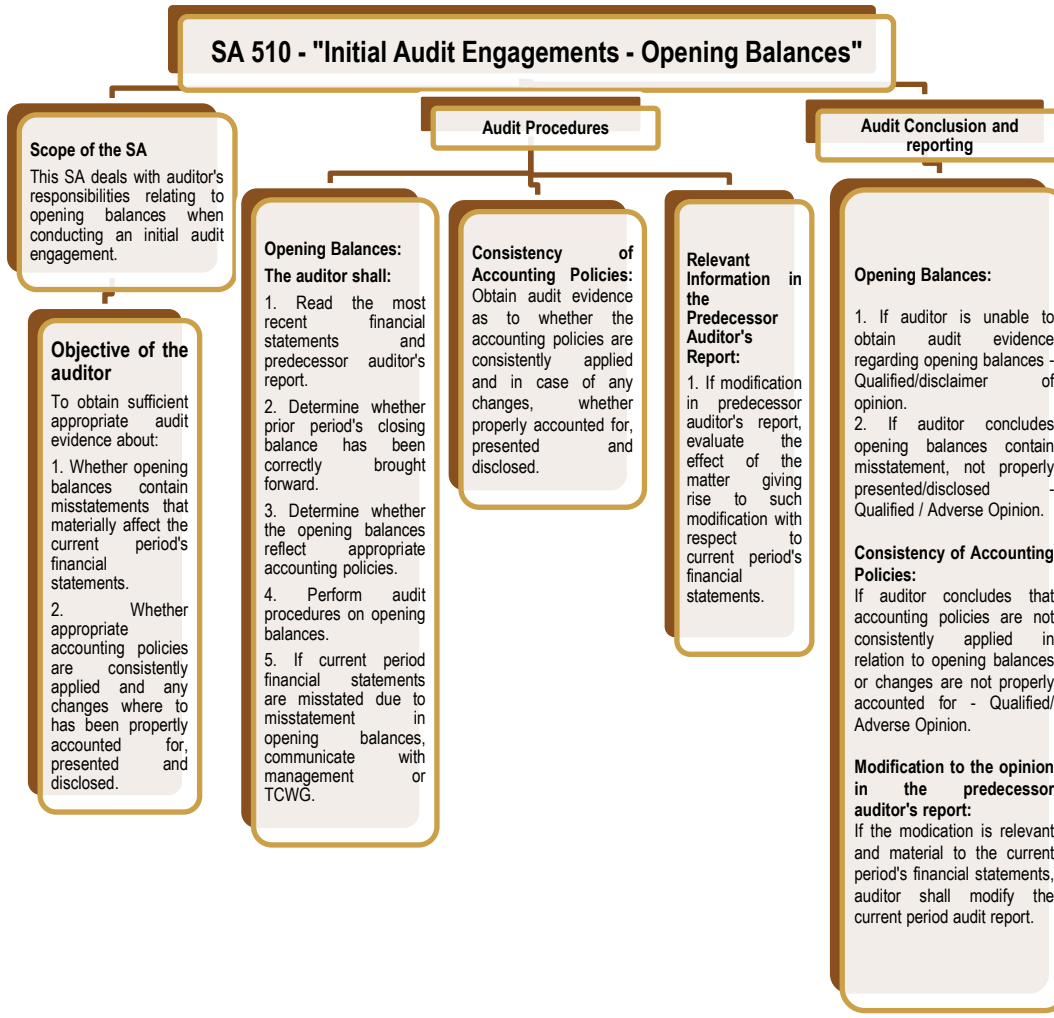
Responses to confirmation requests are received within a week's time. Your article assistant informs you that out of 30 creditors, GST registrations of 25 creditors have been cancelled during financial year 2023-24 itself by collating information from GST portal. He further informs you that there are no fresh registrations pertaining to PANs of these parties.

How would you proceed to deal with the situation as an auditor of the company?

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4. SA 510 INITIAL AUDIT ENGAGEMENTS-OPENING BALANCES

SA 510 deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. An initial audit engagement is an engagement in which either the financial statements for prior period were not audited or were audited by a predecessor auditor.



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TEST YOUR UNDERSTANDING 6

CA M. Hussain is appointed as auditor of a firm for the year 2023-24 on 31st July, 2023. The accounts of the firm were unaudited in the year 2022-23. The firm had material inventories reflected in its financial statements even as on close of 31st March, 2023.

He is performing audit procedures, including attending physical inventory count as on 31st March 2024. However, there is a lingering doubt in his mind regarding opening inventories reflected in financial statements.

Does there exist any responsibility on his part in such a situation?

5. SA 530 AUDIT SAMPLING

SA 530 deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details and evaluating the results from the sample.

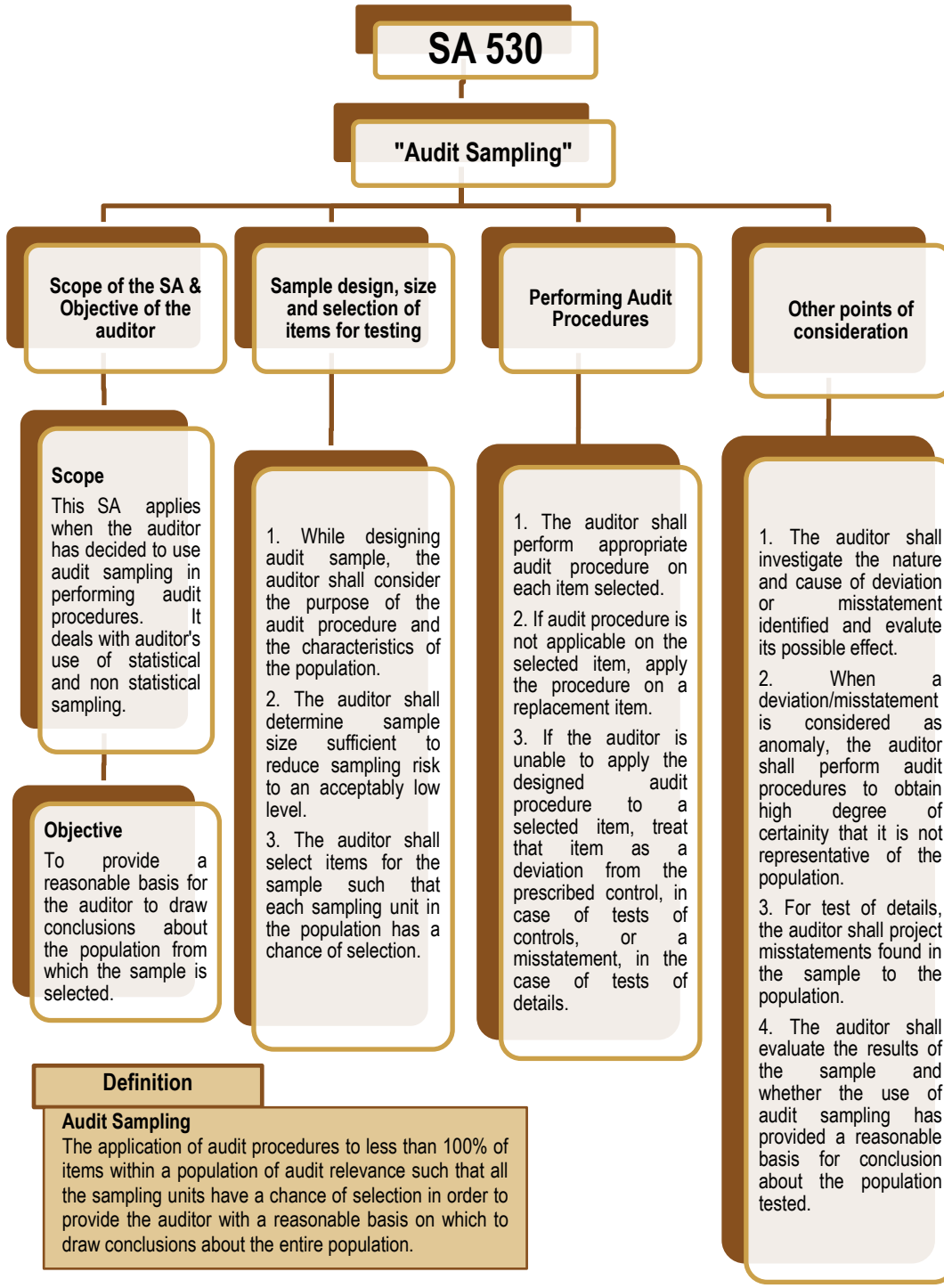
TEST YOUR UNDERSTANDING 7

CA Ritesh has drawn some samples during the audit of a manufacturing company for testing controls as well as for tests of details. On the basis of the samples selected, he reaches an erroneous conclusion that access controls on applications are less effective.

Further, on the basis of samples selected, he concludes erroneously that work-in progress inventories amounting to ₹ 5 crore in financial statements are materially misstated.

Outlining the above risk involved, discuss how it is going to affect his audit of the company.

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6. SA 550 RELATED PARTIES

SA 550- " Related Parties"

Scope of the SA

This SA deals with the auditor's responsibilities regarding related party relationships and transactions. It expands on how SA 315, SA 330, SA 240 are to be applied in relation to related party relationships and transactions.

Objectives of the auditor

I. To obtain an understanding of the related party transactions to:
1. recognize fraud risk factors arising from such transactions.
2. conclude whether financial statements in so far as they are affected by such transactions:
a) achieve a true and fair presentation.
b) are not misleading.

II. To obtain audit evidence as to whether the related party transactions are properly identified, accounted for, and disclosed in the financial statements.

Requirements of the SA

1. Risk Assessment procedures and related activities.
2. Understanding the Entity's related party relationships and transactions.
3. Maintaining alertness for related party information when reviewing records or documents.
4. Sharing related party information with the Engagement team.
5. Identification and assessment of the risk of material misstatement associated with related party transactions and relationships.
6. Responses to the Risks of Material Misstatement associated with related party relationships and transactions.

Identification of previously unidentified or undisclosed related party transactions.

1. Auditor shall determine whether the underlying circumstances confirm the existence of such transactions.
2. Communicate within the team.
3. Request management to identify all transactions with newly identified related parties.
4. Perform more substantive procedures.
5. Reconsider risks with respect to other related parties.
6. If non disclosure by the management appears intentional, evaluate the implications for the audit.

Identified significant related party transactions outside the entity's normal course of business

1. Inspect the underlying contracts and evaluate:
a) the business rationale of the transactions.
b) whether the terms of transactions are consistent with management's explanations.
c) whether such transactions have been properly accounted for.
2. Obtain audit evidence that the transactions have been appropriately authorised and approved.

Other important points

The auditor shall obatin Written Representation that:
a) all the related parties and related party transactions have been disclosed to the auditor and
b) all such transactions have been properly accounted for and disclosed.

Communication with TCWG
The auditor shall communicate with TCWG significant matters arising during the audit in connection with the entity's related parties.

Documentation:
The auditor shall include in audit documentation names of the related parties and the nature of the related party transactions.

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SA 550 deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it applies in relation to risks of material misstatement associated with related party relationships and transactions.

TEST YOUR UNDERSTANDING 8

"Living Well Private Limited" is engaged in the manufacturing and export of floor coverings. Such products are labour-intensive and do not require much capital investment in machinery. The company has no plans to diversify in other product lines. Its directors are also holding significant interest in another company "My Living Private Limited" engaged in manufacturing of blankets using capital intensive machinery.

During the audit of "My Living Private Limited", it was noticed that the company has sold machinery of ₹ 1 crore to "Living Well Private Limited" during the year. The transaction has been done at normal market rates applicable to such used machinery.

How do you view the above transaction as auditor of "My Living Private Limited"?

Case Study 1

Honest Speciality Chemicals Private Limited is a company with a turnover of ₹ 1,000 crore having plants in Khopoli, Mahad, and Ankleshwar for manufacturing various products for fertilizer units, cosmetics and paint industry, etc. The company has built up a good reputation, and apart from the domestic market, it exports to the European market and the Middle East. The company is a closely held company owned by three friends and their family members. The types of materials handled and produced are hazardous.

Following further latest information relating to the company is as under: -

- The company needs to import key raw materials and is exposed to high risk of price fluctuations and currency risks.
- The company carries high inventory due to the long import cycle and seasonal sales pattern.
- The working capital is almost 60% blocked in inventory and rest in receivables.
- The company has huge investments in plant and machinery financed through term loans from financial institutions.
- Since the company has large imports, it buys import licenses from the open market.

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- The company has received notices from the custom department for using fake licenses for importing materials without paying duty. The company has filed an appeal against the said notice and the same is pending with the Appellate Tribunal. The amount involved is material and, along with interest and penalty, could be more than 10% of turnover.
- The company has liquid chemicals stored in huge tanks.
- The powdered form of chemicals is stored in standard-sized drums.
- Few items of stock like coal, sulphur are lying in the open area.
- The company has huge domestic sales on a consignment basis, and vast quantities of finished inventories are lying with the consignees across India.
- The company has received an order from NGT to pay a fine of INR 1.5 crores for the emission of toxic chemicals into the air and water. The company has filed an appeal against the said order.
- The type of plant is such that it has to be a continuous process, and at any time, huge quantities of materials are in process.
- Raw Materials are stored in huge tanks located 2 kilometers from the plant, and to transport the chemicals (liquid), there is a network of pipes connecting them, and at any point in time, there are huge quantities of materials lying in the pipeline.
- The company has prepared its inventory details by involving a management expert.
- During the year, the previous auditor resigned, and a new auditor got appointed.

Theoretical Questions

Based on the case study, please advise the auditor on the important aspects of carrying out the audit procedures to obtain sufficient appropriate audit evidence in respect of the following: -

1. *Which audit procedures are required for verifying the existence and condition of company's inventories with specific reference to its nature of operations?*

2. *The company has prepared inventory details by involving a management's expert. Elaborating upon its rationale, discuss responsibilities of auditor in regard to information prepared by company involving such an expert.*

3. *What additional procedures does the auditor need to carry out in respect of stocks lying with consignees all over the country?*

4. *What procedures should the auditor need to undertake for litigation matters?*

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Multiple Choice Questions

1. *The objectivity of the management's expert is likely to be lesser if:*

(a) The expert is competent

(b) The expert is capable

(c) The expert has relevant experience

(d) The expert is employed by the entity

2. *Which of the following matter is irrelevant for auditor in planning attendance at physical inventory counts?*

(a) Nature of inventory

(b) The timing of physical inventory counting

(c) The nature of the internal control related to inventory

(d) Whether 100% of inventory is covered in the count

3. *External confirmations for receivables are not reliable if:*

(a) The response directly received by the auditor

(b) The confirmation has come from the address of the confirming party

(c) The confirmation is signed by the plant manager

(d) The confirmation is positive confirmation

4. *The new auditor planned certain procedures with respect to opening balances. Which of the following procedures is not in accordance with SA 510?*

(a) Reading the most recent financial statements and audit report

(b) Where the prior period report is modified, the impact on the current period

(c) Correctly bringing forward of prior period closing balances

(d) Ascertaining whether predecessor auditor had attended physical inventory count

Answers to Theoretical Questions

1. The auditor needs to obtain sufficient appropriate audit evidence regarding existence and condition of inventory.

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For the above, the auditor needs to do all the following: -

(a) Attendance at physical inventory counting to:

(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting like:

- The existence of appropriate control activities: collection of used physical inventory count records, accounting for unused physical inventory count records, count and recount procedures.
- The accurate identification of the stage of completion of work-in-progress, of slow moving, obsolete, or damaged items and of inventory lying in tanks, in pipes and in open areas.
- The procedures used to estimate physical quantities, for liquid chemicals lying in process, tanks, pipelines, in open areas like coal pile, sulphur pile, etc.
- Control over the moment of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.

(b) Observe the performance of Management's count procedure by observing the control over the movement of inventory before, during and after the count to determine adequacy and effectiveness of count procedure.

(c) Inspect the inventory to assist in identifying obsolete, damaged or ageing of inventory.

(d) Perform the test counts to obtain the sufficient appropriate audit evidence

(i) By tracing items selected from the physical inventory to management's count records,

(ii) By obtaining copies of Management's completed physical inventory count records

(e) Cross matching the final inventory records with the actual inventory count results.

2. The company deals with speciality chemicals which are in liquid condition, powdered condition, lying in huge tanks or in plants under process, lying in pipelines or lying in open areas like coal and sulphur. The unit of measurement for each of the above categories may be different and could involve technical and mathematical principles involving technical and

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scientific expertise. Keeping these matters in view, inventory details have been prepared by involving management's expert.

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, having regard to the significance of that expert's work for the auditor's purposes:

(a) Evaluate the competence, capabilities and objectivity of that expert

(b) Obtain an understanding of the work of that expert and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

3. Apart from obtaining the confirmation from the third party as to the quantities and condition of the inventory held on behalf of the entity, the auditor may perform the following other audit procedures:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory,
- Obtaining another auditor's report or a service auditor's report on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties

4. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity by:-

- Inquiry of management and, where applicable, others within the entity including in-house legal counsel.
- Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel.
- Reviewing legal expense account.

The legal claims involving customs and fines of NGT are material. In such circumstances if auditor assesses risk of material misstatements regarding litigation, he can seek letter of specific inquiry from the external legal counsel including: -

- A list of litigation and claims

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- Where applicable, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including cost involved and
- A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered incomplete or incorrect.
- The auditor may seek a meeting with the external legal counsel if the matter is having significant risk, it is complex or there is disagreement between management assertion and legal counsel's views.
- Obtaining written representation from the management and where appropriate those charged with governance that all the known actual or possible litigation and claims whose effects should be considered when preparing the financial statement have been disclosed to the auditor and appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

MCQ answers

1. (d) **2.** (d) **3.** (c) **4.** (d)

Case Study 2

"Trustworthy Real Estate Private Limited" with Mr. Bharose Lal as MD along with his wife, Maya, owned the company.

The company had floated one SPV *"Real Trust Developers Private Limited"* in which a foreign entity became a Joint Venture partner with a 50% stake.

The venture was formed with its Head Office in Mumbai to invest in SRA projects (Slum Rehabilitation Authority) and develop them into commercial units for sale.

Mr. Bharose Lal was going through a rough patch in his life. He was in financial difficulty and had mounting dues and huge outstanding exposure to banks and suppliers in his companies. He approached one of his rich friends Mrs. Maya. Mrs. Maya had an expensive lifestyle and was always short of funds to maintain her lifestyle. Mr. Bharose Lal sensed a golden opportunity in the new venture because the foreign partner had no knowledge of Indian regulations and how the SRA projects worked and was solely dependent on the local partner to get all the permissions, scouting for the projects, getting consents from the slum dwellers for the project, giving contracts for the construction of projects and such matters.

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M/S ABC and Company, Chartered Accountants were appointed as the auditor of the joint venture, and the engagement team was headed by CA Sceptic, who had, in his stint with the firm, was instrumental in unearthing two major frauds and had the ability to sniff out any such scenarios.

Mr. Bharose Lal has a dominant personality and a powerful influence on functioning, and everybody looks to him for guidance. The governance structure was very poor in the organization, and Mr. Bharose Lal used to dictate the decisions. Even though as part of the Joint Venture, there was a detailed governance structure and policies and procedures in place for the decision-making process at the joint venture. However, the representative on the board of the Joint Venture of the foreign partner who had shifted to India to supervise the SRA project had grown friendly with Mr. Bharose Lal, and Mr. Bharose Lal had even gone out of the way to help him get good accommodation and second- hand Mercedes. Often, they both go to a club in the evening for a drink.

The dealings in the SRA project are not very transparent and above board but are very opaque. Given the above situation, CA Sceptic wants to discuss with the audit team areas and situations where the risk of material misstatement is possible and there are chances of having an undisclosed related party relationship to misappropriate the funds.

Theoretical Questions

1. *Please guide the engagement team on the further course of action as per SA 550.*

2. *What are fraud risk factors in given case?*

3. *Given the situation that each partner in the joint venture has to bring into the entity a contribution of 5 crores each and given the situation that Mr. Bharose Lal had appointed one agency, the name Useless & Sons Private Limited, to get consent from the slum dwellers, for which the agency was paid 20 crores as Kitty to get the job done.*

CA Sceptic inclines that there is some connection between the 20 crores paid and, simultaneously, within a short span, the infusion of INR 5 crores as equity contribution by Mr. Bharose Lal.

Please guide CA Sceptic in establishing this link based on the guidance available in SA 550 and SA 240.

What additional audit procedures does his team need to undertake for the conclusion?

4. *If, based on additional audit procedures undertaken by CA Sceptic, it is established that there is a likelihood of misappropriation of funds and the financial statements as a whole may be materially misstated, how CA Sceptic needs to plan the future course of action?*

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Multiple Choice Questions

1. *Which of the following best describes the method that Mr. Bharose Lal can indulge to commit fraud?*

(a) Concealing and not disclosing facts that could affect the amounts recorded in financial statements.

(b) Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

(c) Causing an entity to pay for goods or services not received.

(d) Using undisclosed business partners to misappropriate funds in the garb of making a business transaction and thus siphoning off the funds.

2. *In the given case scenario, the main factor giving rise to risk of material misstatement is:*

(a) The expensive lifestyle of owners.

(b) Appointment of an auditor having experience in unearthing of frauds

(c) The deteriorating financial condition of the owner's business.

(d) The vulnerability and dependence of the foreign partner on the local partner.

3. *In the given case scenario, which is the most important red flag for auditor:*

(a) Expensive lifestyle

(b) Undisclosed related party relationships to siphon off the funds.

(c) Financial crunch

(d) The dominant influence of the owners

4. *Which of the following is not a fraud risk factor?*

(a) Dominant influence of the owners

(b) Expensive lifestyle

(c) Fraud risk due to the nature of the industry

(d) Floating of a new SPV itself

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Answers to Theoretical Questions

1. The engagement team shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.

- The nature and extent of the entity's relationships and transactions with related parties as identified independently by the Auditor by verification of MBP-1 data and data available on MCA website relating to directors and companies, etc.
- An emphasis on the importance of maintaining Professional Skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organisational structure, use of special purpose entities off-balance sheet transactions, or an inadequate information system).
- The records or documents that may indicate the existence of related party relationships or transactions.
- The importance of management and those charged with governance attached to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirement), and the related risk of Management override of relevant controls.
- In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

  (a) How special-purpose entities controlled by management might be used to facilitate earnings management

  (b) How transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

    - An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.

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- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behaviour or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

2. The fraud risk factors are the events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

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The fraud risk factors are classified based on the three conditions that are generally present when fraud exists:

(i) An incentive or pressure to commit fraud

(ii) A perceived opportunity to commit fraud

(iii) An ability to rationalize fraudulent actions.

In the given case scenario following fraud risk factors can be segregated in the 2 conditions of incentive or pressure to commit fraud in a perceived opportunity to commit fraud.

1) An incentive or pressure to commit fraud:

- Financial difficulty with huge outstanding dues towards vendors and Financial Institutions.
- Expensive lifestyle.
- Requirement to fund ₹ 5 crore as equity contribution in the SPV.

2) A perceived opportunity to commit fraud:

- Dependency of the foreign partner and no knowledge of the foreign partner of local laws and the SRA business model in India
- The risk is due to the way the real estate industry functions and particularly risk due to the SRA business model.
- Dominant personality of MD, which can lead to management override of controls for undisclosed business relationships with M/s. Useless and Sons (P) Ltd.

3. If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditors, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

In such situations, the auditor shall:

- Promptly communicate the relevant information to the other members of the engagement team in order to assist them in determining whether this information affects the results of, and conclusions drawn from risk assessment procedures already performed, including whether the risk of material misstatement needs to be reassessed.

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- Where the applicable financial reporting framework establishes related party requirements:

  (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and

  (ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;

  - Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions.
  - Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclose to the auditor, and perform additional audit procedures as necessary; and
  - If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit. In such cases, the requirements and guidance in SA-240 regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant where management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor. The auditor may also consider whether it is necessary to re-evaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.
  - The Auditor needs to carry out verification and inspection of the ownership structure and the review of the financial statements of M/s. Useless and Sons (P) Ltd through the MCA website and establish the nexus between the two.
  - The Auditor needs to carry out an inspection of the data filed by Mr. Bharose Lal for his group companies to establish any past transactions/relationships between the two entities.
  - The Auditor needs to ask for all the documents for the utilization of INR 20 crore and can investigate by visiting the parties involved and asking for confirmation directly.

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4. The Auditor needs to reassess the reliability of evidence previously obtained as there are doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation.

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is the requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

MCQ answers

1. (d) **2.** (d) **3.** (b) **4.** (d)

Integrated Case Scenario

Black & White Ltd. is into the business of manufacturing readymade garments in Amritsar. It procures all the raw material required for its production from Punjab, Himachal Pradesh & J&K. Its sales market, however, covers almost all the northern parts of the country. CA Anu is the engagement partner of Maheshwari & Co appointed as the statutory auditor of the company. She calls for a meeting of the engagement team to delegate work and responsibilities. During the audit, the engagement team comes across the following facts:-

- Woolen Private Limited is one of the vendors of the company from which the company has been purchasing wool for many years on a current account basis, but no single purchase has been made in the last nine months, and the outstanding balance stands as it is in the books of accounts. CA Anu wants to confirm the balance and requests the CFO of the company for sending a balance confirmation request to Woolen Private Ltd., to which he refuses and is not willing.

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- The Fashion Jingo Ltd. is one of the customers of the company and hasn't replied to CA Anu's positive balance confirmation request sent.
- Mr. X, one of the fashion designers, had sold his designs to the company but owing to a dispute, the contract got cancelled, and now both the parties are under litigation in the local court of law. The engagement team is guided as to the procedures to be designed and performed to identify this matter.
- CA Anu simultaneously seeks direct communication with the company's external legal counsel sensing the risk of material misstatement. However, it ends up in vain as the external legal counsel, Mr. Chadha, refuses to comment. She is unable to obtain sufficient appropriate audit evidence in this regard through alternative audit procedures either.

The team documents all the relevant information w.r.t. the above facts, and CA Anu issues the audit report accordingly.

Multiple Choice Questions

1. *Fashion Jingo Ltd. has not responded to CA Anu's request. What would be proper course of action for her in such a situation?*

(a) Perform alternative audit procedures

(b) Consider it as a negative confirmation

(c) Give a Qualified opinion

(d) Should visit the customer company premises herself and confirm the balance on the spot.

2. *With respect to Advocate Chadha's cold shoulder to CA Anu's request, what she should do?*

(a) Modify her audit opinion

(b) Give an unqualified opinion

(c) Give a disclaimer of opinion

(d) Withdraw from this engagement

3. *What should be CA Anu's first and foremost response in the case of request made relating to balance confirmation from Woolen Pvt. Ltd.?*

(a) Perform alternate audit procedures.

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(b) *Withdraw from the engagement.*

(c) *Communicate with Those charged with Governance telling the effects on his audit opinion.*

(d) *Inquire as to the reasons behind the management's response and seek audit evidence as to its validity and reasonableness*.

4. *Which of the following procedures will not be performed by the engagement team as audit procedures while dealing with the case of Mr. X?*

(a) *Inquiry of Management.*

(b) *Inquiry of Mr. X*

(c) *Reviewing Minutes of Meetings*

(d) *Reviewing Legal expenses account*

Answer to MCQs of Integrated Case Scenario

1. (a) **2.** (a) **3.** (d) **4.** (b)

Key Takeaways

- SA 500 deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.
- The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.
- Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.
- Reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability.

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- When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes, evaluate competence, capability and objectivity of such an expert besides obtaining understanding of his work. Further, appropriateness of management's expert work as audit evidence for relevant assertion has also to be evaluated.
- SA 501 deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.
- When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attendance at physical inventory counting, unless impracticable.
- The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.
- Segment information refers to information about different types of products and services of an enterprise and its operations in different geographical areas. In accordance with SA 501, the auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework.
- SA 505 deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 500. It is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.
- SA 510 deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. An initial audit engagement is an engagement in which either the financial statements for prior period were not audited or were audited by a predecessor auditor.
- SA 530 deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details and evaluating the results from the sample.

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- The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.
- Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.
- Whatever may be the approach, statistical sampling or non-statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.
- SA 550 deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM:
SCAN ME !

Note : Content of SA 500- Audit Evidence; SA 501-Audit Evidence - Specific Considerations for Selected Items; SA 505-External Confirmations; SA 510- Initial Audit Engagements – Opening Balances; SA 530 Audit Sampling & SA 550 - Related Parties is covered in depth at Intermediate level. Thus, application part of the above SAs may be discussed in the form of Case Study at Final level.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Coccyx Ltd. supplies navy uniforms across the country. The company has 3 warehouses at different locations throughout the India and 5 warehouses at the borders. The major stocks are generally supplied from the borders. Coccyx Ltd. appointed M/s OPAQE & Co. to conduct its audit for the financial year 2023-24. Mr. P, partner of M/s OPAQE & Co., attended all the*

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physical inventory counting conducted throughout the India but could not attend the same at borders due to some unavoidable reason.

You are required to advise M/s OPAQE & Co.,

(I) How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained?

(II) How is an auditor supposed to deal when attendance at physical inventory counting is impracticable?

2. *GHK Associates, Chartered Accountants, conducting the audit of PBS Ltd., a listed company for the year ended 31-03-2024 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GHK Associates want to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GHK Associates with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant Standards on Auditing.*

3. *Chintamani Ltd appoints Chintan & Mani as statutory auditors for the financial year 2023-24. Chintan & Mani seem to have different opinions on the Audit approach to be adopted for audit of Chintamani Ltd. Mani is of the opinion that 100% checking is not required and they can rely on Audit Sampling techniques in order to provide them a reasonable basis on which they can draw conclusions about the entire population.*

Chintan is concerned that whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

You are required to guide Chintan about his role if audit sampling has not provided a reasonable basis for conclusions about the population that has been tested in accordance with SA 530.

4. *During the audit of Star Ltd., a company engaged in the production of paper, the auditor received certain confirmation for the balances of trade payables outstanding in the balance sheet through external confirmation by "Negative Confirmation Request". In the list of trade payables, there are number of small balances except one which is an old outstanding of ₹ 20 lakhs for which no confirmation was received. Comment with respect to Standards of Auditing relating to the confirmation process and how to deal with the non-receipt of confirmation.*

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5. *Mr. Atharv, while conducting the audit of Black Mountain Mining Ltd., which is involved in phosphate mining, decided to engage an auditor's expert to assess environmental liabilities and site clean-up costs. Black Mountain Mining Ltd. re-appointed Mr. Aman as an independent expert for this task. For the past five years, the management has consistently re-appointed Mr. Aman. He calculated the environmental liabilities for both completed mining sites and sites scheduled for closure in the near future, including provisions for clean-up costs. Management accepted his assessment.*

Mr. Atharv, after performing the inquiries with management, was of the opinion that the objectivity of the independent expert cannot be questioned just because he was appointed by management as their expert. Hence, there is no need to raise a question on the objectivity of Mr. Aman or on his work performed for the company. However, the audit partner was of the opinion that the audit team needs to evaluate the objectivity of an expert engaged by the entity, irrespective of the fact that he was appointed as an independent expert.

Guide the audit partner and Mr. Atharv with respect to requirements pertaining to evaluating the objectivity of the management expert.

6. *While conducting the statutory audit of Tasty Foods Limited, CA. Careful has planned attendance at physical inventory count of the company from 29th March to 31st March 2024. The company is engaged in the business of extracting rice from paddy grains and caters to domestic as well as international market particularly in Gulf region. It has its plant spread in an area of about 20 acres located in National Capital Region (NCR). Paddies contained in jute bags of nearly standard sizes is purchased from dealers/agents. It is stored in heaps on pallets (kind of wooden structures) in an open area covered by protective sheets and in steel silos (silos are huge steel containers with measuring strain gauges) in company's premises.*

The company mainly produces three rice brands viz. "Raja" and "Shehzada" (both for the domestic market) and "Badshah" (for the international market). The process of obtaining rice from paddy consists of various steps like cleaning of paddy, removing outer husk layer from paddy grains to obtain brown rice, whitening, polishing, grading and sorting, packaging which is accomplished by means of various types of machineries installed in plant.

The company's management has prepared a set of instructions and procedures to be followed for recording and controlling results of company's physical inventory counting which are listed as under: -

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- ***The physical inventory count process is to be supervised by a responsible officer of company responsible for storage functions.***
- ***There should be no disturbance to the routine process of receiving goods and despatch during the counting time period.***
- ***Counting process is to be undertaken by constituting different teams of 3 members each for counting/verifying raw material, work in progress and finished goods.***
- ***Paddy in steel silos is to be estimated using their capacity.***
- ***Quantity of work in progress is to be estimated considering plant capacity as whole.***
- ***The responsible officer should ensure that stocks have been counted/verified in all areas.***

Before proceeding to attend physical inventory count process of company, evaluate management's instructions and procedures sent to CA Careful as stated above. You may suggest modification, addition or removal of such instructions to ensure effective count process.

Answers to Test Your Understanding

1. **Evaluating the Work of Management's Expert:** As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,

   (a) Evaluate the competence, capabilities and objectivity of that expert;

   (b) Obtain an understanding of the work of that expert; and

   (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

   The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert; discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

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Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

(i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements.

(ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

(iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

In the instant case, BBNS Ltd. accepted the gratuity liability valuation based on the certificate issued by an expert i.e., a qualified actuary who is management's expert. Here the basis for computation and valuation is taken as age 65 years by the actuary, which is not correct as company is considering proposal to increase the retirement age from existing age to 65 years. Therefore, assumptions and methods used by the management's expert are not appropriate for financial reporting purposes. Hence, the auditor may qualify the report accordingly.

2. The given situation does not highlight the impracticability of attendance at inventory counting. It only shows that the auditor is unable to attend physical inventory counting due to unforeseen circumstances arising out of agitation by protestors. It has led to the inaccessibility of the plant site for a month. The blockade is lifted after a month.

SA 501 states that if the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date and perform audit procedures on intervening transactions. Therefore, the auditor should attend the physical inventory count after the blockade is lifted and perform audit procedures on intervening transactions.

3. SA 501 states that when audit procedures performed indicate that material litigation or claims may exist, the auditor shall seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor.

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Therefore, her approach in communicating with an external lawyer is not correct. She needs to make management aware of her intention to communicate directly with the lawyer. The letter of inquiry has to be prepared by management and sent by her.

Her purpose in corresponding with the lawyer of the company is to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. It is due to the reason that litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

4. SA 501 states that when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

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

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

It further states that where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party.

Examples of other audit procedures include:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties

In the given case, the integrity of the third party appears to be doubtful in view of DGGI raids and his possible involvement in a fake billing scam. He has already been behind bars.

Keeping in view the above, besides obtaining confirmation from such party, he may attend a third party's physical counting or ask some other auditor to attend physical counting as on reporting date, depending upon practical considerations. He can also inspect the record of

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goods sent and received back from such party by tracing it to challans, e-ways bills etc. and correlate the above information.

5. SA 505 states that if the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

In the instant case, GST registrations of 25 concerns have been cancelled in the year 2023-24. It indicates that businesses on those addresses were closed. Further, there are no fresh registrations pertaining to the PANs of these parties. However, the auditor sent external confirmation requests in March 2024, which were duly responded. It raises questions on the reliability of responses received.

SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include:

- Was received by the auditor indirectly or
- Appeared not to come from the originally intended confirming party.

Keeping in view the circumstances described in the case situation, there is a risk that the response has not come from the originally intended confirming party.

Unreliable responses may indicate a fraud risk factor that requires evaluation.

6. SA 510 states that in conducting an initial audit engagement, one of the objectives of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period's financial statements. The auditor has to evaluate whether audit procedures performed in the current period provide evidence relevant to the opening balances or specific audit procedures are required to be performed to obtain evidence regarding the opening balances.

In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

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- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cut-off.

7. The described risk is sampling risk. It is a risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.

In the given case, the auditor has arrived at erroneous conclusions on the basis of the samples selected. In the case of a test of controls, he has concluded that access controls are less effective than they actually are. In the case of a test of details, he has concluded erroneously that a material misstatement exists when in fact, it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

8. In respect of significantly related party transactions outside the normal course of business of an entity, it is the responsibility of the auditor, in accordance with SA 550, to evaluate the business rationale or lack thereof of transactions that may have been entered to indulge in fraudulent financial reporting or conceal misappropriation of assets.

The auditor has to seek to understand the business rationale of such a transaction from a related party's perspective. It would help him understand the economic reality of such a transaction and why it was carried out.

In the given situation, there is no primary rationale for such a transaction. Living Well Private Limited does not manufacture blankets, and the purchase of part of old machinery pertaining to blanket manufacturing has no rationale for it primarily. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

Hints /Answers to Theoretical Questions

1. **(I)** **Special Consideration with Regard to Inventory:** As per SA 501 "Audit Evidence-Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(1) Attendance at physical inventory counting, unless impracticable, to:

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(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;

(ii) Observe the performance of management's count procedures;

(iii) Inspect the inventory; and

(iv) Perform test counts; and

(2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

(II) Attendance at Physical Inventory Counting Not Practicable: In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

Further, where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In some cases, though, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 on Modifications to the Opinion in the Independent Auditor's Report, requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

2. The auditors, GHK Associates wanted to ensure and obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by obtaining an understanding of the methods used by management in determining segment information. SA 501 guides in this regard. As per SA 501- "Audit Evidence—Specific Considerations for Selected Items", example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are

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likely to result in disclosure in accordance with the applicable financial reporting framework include:

(i) Sales, transfers and charges between segments, and elimination of inter-segment amounts.

(ii) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.

(iii) The allocation of assets and costs among segments.

(iv) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

3. As per SA 530, "Audit Sampling", the auditor shall evaluate:

(a) The results of the sample; and

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

(I) Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or

(II) Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

4. **External Confirmation:** As per SA 505, "External Confirmations", negative confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.

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Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise.

In the instant case, while performing audit of Star Limited, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet. One of the old outstanding of ₹ 20 lakh has not sent the confirmation on the credit balance. In case of non-response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non-response for negative confirmation request does not mean that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.

5. ***As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, have regard to the significance of that expert's work for the auditor's purposes evaluate the competence, capabilities and objectivity of that expert.***

A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures). Although safeguards cannot eliminate all threats to a management expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- ***Financial interests.***

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- *Business and personal relationships.*
- *Provision of other services.*

In the current case, Black Mountain Mining Ltd. re-appointed Mr. Aman for this engagement as an independent expert. The audit team was of the view that the objectivity of the independent expert cannot be questioned just because he was appointed by management as their expert. However, the audit partner had a contrary view.

Hence, the audit team should evaluate the objectivity of an expert engaged by the entity as the threat to objectivity, created by being an employee of the entity, will always be present. An expert appointed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity. As a result, audit partner Atharva is correct in his view.

6. *The set of instructions and procedures given in the case scenario are incomplete and not properly followed, which are discussed as under:*

- *The physical inventory count process should be supervised by a responsible officer of the company, preferably from finance department. The supervision of the count process should not be done by person responsible for storage function. However, storage in-charge of each area should be present during inventory count process for co-ordination and facilitation.*
- *During inventory count process, inward and outward movement of goods should not be allowed as allowing such movement may distort the results or make it difficult to arrive at proper results.*
- *The instruction relating to the constitution of teams for counting process does not specify that counting shall be undertaken by members drawn from departments not connected with storage function. For example, these members may be from the finance department. Further, within each team, duties should be fixed separately for counting and recording on serially numbered count sheets. It is nowhere stated that once counting in an area is complete, certain distinctive marks or tags are required to be put.*
- *Count sheets should contain description of products in accordance with inventory records of company.*

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- *The management's instructions are silent about how team members would proceed with their work. Team members should be provided with lay out plans for different sections/ storage areas so that all areas are covered.*
- *The management's instructions are silent on how paddy lying in open is to be counted and verified. Paddy in jute bags lying in open in heaps should be verified by counting number of bags in one heap. As each bag is of nearly standard size, the quantity of paddy can be determined by counting number of bags in a heap and correlating it with the weight of standard bag.*
- *Paddy in steel silos should be determined using measuring strain gauges on silos. Determining quantity in silos based on silo capacity may lead to wrong results as paddy may have been used from such silos.*
- *Quantities of work in progress should be estimated at each stage of production and not for the plant as a whole. Estimating WIP inventories for plant as a whole would give inaccurate picture of work in progress inventories.*
- *Finished goods inventories need to be counted category wise. Rice bags should be verified by checking the name of brand.*
- *There is no instruction regarding damaged or obsolete stock items particularly in the case of finished goods i.e. rice. Damaged/obsolete inventories should be counted and shifted to a separate area for assessment of their condition and to prevent mix-up with other standard inventories.*
- *Count sheets need to be signed by each team member.*

The responsible officer should ensure that stocks have been counted/verified in all areas and distinctive marks are put to confirm completion of counting.

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CHAPTER 6

COMPLETION AND REVIEW



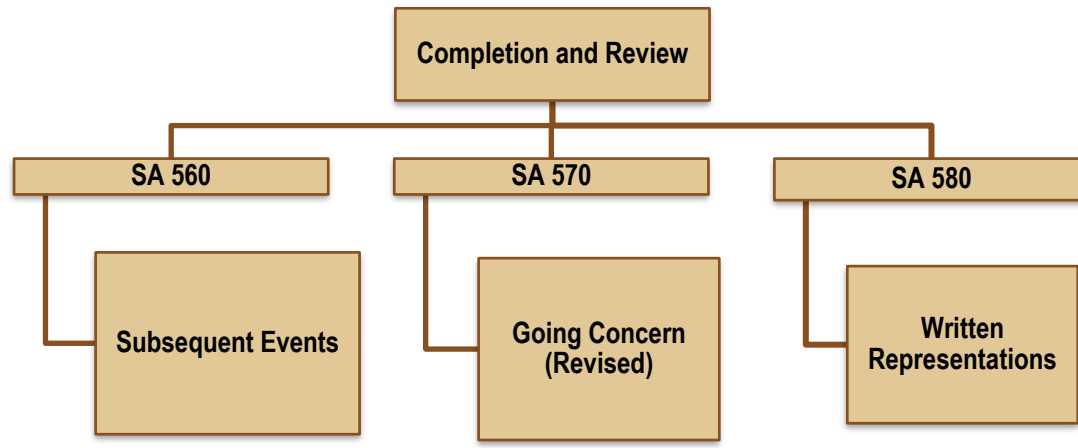
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Refreshen up your knowledge about procedures relating to completion and review
- Glance through relevant SAs-SA 560, SA 570 and SA 580 pictorially
- Gain application-based knowledge of above SAs.
- Understand the concepts through use of analytical examples and case studies.
- Gain knowledge about varied practical situations for an auditor while performing such procedures.

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CHAPTER OVERVIEW



CA Sujatha M is an auditor of a company engaged in manufacturing energy-saving electric lights. As an auditor of the company, she already knew that a devastating fire had taken place in the plant of the company during the year gone by, and the entire building, plant, machinery and inventories were gutted. Estimate of loss to the company's assets was to the tune of ₹ 50 crores. The company had lodged a claim with insurers, but there was no progress on the claim settlement front till the close of the year.

The company's operations have been shut down since then. The company had little money to reinvest in fresh assets on its own. The promoters had put certain personal properties for sale. However, due to the sluggish real estate market, no deals could materialise. Meanwhile, customers of the company had started procuring their requirements from other suppliers.

As an auditor of the company, she was in a dilemma. The main question troubling her related to the ability of the company to restart its operations in such circumstances and to continue as a going concern. She had to complete the audit within the timelines. She was keeping her fingers crossed and adopted a "Wait and watch" policy to consider the impact of any developments regarding claim settlement. There were still four months left. She could wait.

Suddenly one day, she came to know that the forensic lab conducting the examination of samples taken from the fire site had given an adverse report casting doubt upon the genuineness of the claim itself. All hopes for the recovery of losses had dashed.

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The management had provided her a future plan of action to restart the business. She was also provided with a "cash flow forecast" for coming periods. However, she was not convinced regarding expected cash flows. She was of the prima facie view that the company was not going to withstand such a huge loss in the absence of claim money, and its plans were too rosy and impracticable. The negative forensic lab report changed the whole situation.

However, on deeper scrutiny by management, the findings of the forensic lab appeared to be contradictory. The management found gaping loopholes in the said report. The company was earning good margins and was paying handsome taxes. It was in expansion mode. The demand for its products was also growing rapidly. In such a situation, why would one take such a criminal step? The management decided to take it heads on.

While performing her audit procedures, she checked for any updates on the claim. It became known to her that the management of the company had challenged the forensic lab reports by giving a point-wise rebuttal with the insurers. Even officers of the insurance company were not able to digest forensic lab reports. As the management provided video graphics and other digital evidence, the forensic lab was left red-faced. It seemed that extraneous considerations had prevailed in the course of the submission of their report.

The insurance company asked the forensic lab to reconsider their findings in light of the company's submissions. A positive revised report was submitted by the lab to the insurance company. Now, doors had opened for settlement of the claim and resolution of the claim was in sight.

Performing audit procedures regarding subsequent events helped her to identify those conditions that either mitigate or otherwise affect the company's ability to continue as a going concern. Since she was particular about performing procedures regarding subsequent events, she was able to identify mitigating factors affecting uncertainty associated with the outcome of the claim. In light of these developments, she could convince herself about the ability of the company to continue as a going concern.

After performing substantive procedures, certain procedures are still to be performed by the auditor before the audit report is issued. Some of such important procedures include dealing with the effect of subsequent events, obtaining sufficient appropriate evidence regarding the use of going concern assumption by management and obtaining written representations.

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1. SA 560 SUBSEQUENT EVENTS

SA 560- " Subsequent Events"

Scope of the SA	Definitions	Objectives of the auditor	Events occuring between the date of the Financial Statements and date of the auditor's report	Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued	Facts that become known to the auditor after the financial statements have been issued
This SA deals with auditor's responsibilities relating to subsequent events in an audit of financial statements.	**Subsequent Events:** Events occuring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.	Obtain sufficient appropriate audit evidence about whether events occuring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements. Respond appropriately to the facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.	1. The auditor shall perform audit procedures to ensure that all such events have been identified. 2. The auditor shall consider the auditor's risk assessment in determining the nature and extent of such procedures. 3. If such event is identified, determine whether such event is appropriately reflected in financial statements. 4. Obtain Written Representation that all such events have been adjusted or disclosed.	1. Discuss the matter with management or TCWG. 2. Determine whether the financial statements need amendment. 3. Inquire how management intends to address the matter in the financial statements. **If management amends the financial statements, auditor should extend the audit procedures and** 1. Either amend the audit report to include an additional date restricted to the amendment. 2.Or provide a new/ amended report including a statement in EOM/ OM para. **If management doesn't amend the financial statements.** 1. If audit report not yet provided to the management, modify the opinion. 2. If audit report has already been provided to the management, notify TCWG not to issue it to third parties. If still issued then take appropriate action to prevent reliance on the auditor's report.	1. Discuss the matter with management or TCWG. 2. Determine whether the financial statements need amendment. 3. Inquire how management intends to address the matter in the financial statements. **Review if management has taken steps to inform about the situation to everyone in receipt of the previously issued financial statements.** 1. If steps taken, issue new/ amended report with EOM/ OM para. 2.If steps not taken, then take appropriate steps to prevent reliance on the auditor's report.

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SA 560 deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. The objectives of the auditor in this regard are to obtain sufficient appropriate evidence about whether such events are appropriately adjusted or disclosed in financial statements. Further, in case some facts have come to his knowledge after date of auditor's report, to respond to those facts such that had they been known to him at the date of the report, they may have caused him to amend the auditor's report.

TEST YOUR UNDERSTANDING 1

"Move Fast Limited" is engaged in the manufacturing of shoes and slippers located in Bahadurgarh in Haryana. Due to unprecedented rains in the area in the month of September 2023, many areas of the town got inundated due to the choking of sewer systems. As a result of the above, the company's premises located in town were also affected, resulting in damage of stocks.

The company has lodged a claim with the insurance company for ₹ 1 crore, and the same is shown as a claim receivable as of 31st March 2024, as the claim was not settled at year end.

The insurance surveyor appointed in the case submitted a report to the insurance company recommending a claim of ₹45 lacs in the month of April 2024. The company has also given its consent for the same, and the settled amount of ₹45 lacs was transferred to the bank account of the company on 15th May 2024.

You have just finished performing substantive procedures of the company by the end of May 2024. Is there any responsibility cast upon you as auditor of the company in the above situation?

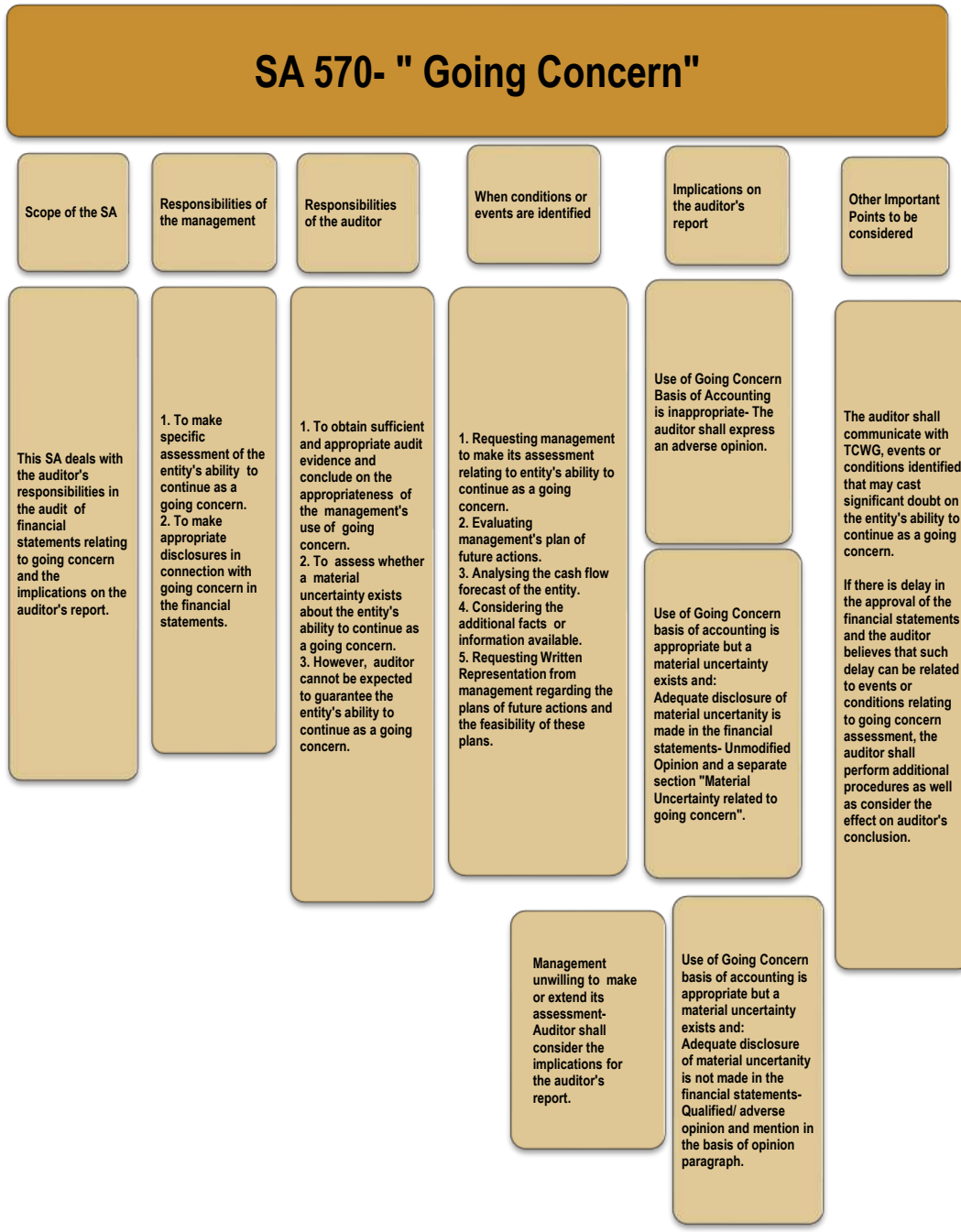
TEST YOUR UNDERSTANDING 2

CA Anuj is the auditor of a listed company, and he is in the midst of conducting an audit of the said company for the financial year ending 31st March 2024. At a meeting of the Board of Directors held on 17th April 2024, a dividend of ₹ 1 crore is proposed to equity shareholders @ ₹10/- per share, and such a proposal has a good chance of being approved in the AGM of the company to be held after few months.

His audit procedures are near completion. He is contemplating finalizing the audit report by 31st July 2024. Is there any responsibility thrust upon him as an auditor of the company?

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2. SA 570 GOING CONCERN



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

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding use of the going concern basis of accounting in the preparation of the financial statements by the management. On the basis of evidence obtained, it is concluded whether a material uncertainty exists relating to events or conditions that may cast a significant doubt on the entity's ability to continue as a going concern.

TEST YOUR UNDERSTANDING 3

CA Somya is auditor of a company engaged in rearing of poultry birds and obtaining eggs therefrom. The company has performed very well since its incorporation in 2013. Its sales had also grown and the company had expanded its market from the native northern state of promoters to far-flung areas in eastern parts of country.

However, since last two years, company's fortunes have nosedived. First, due to the effects of the pandemic and then due to recurrent outbreaks of bird flu thrice in a span of two years. The company's sales have dipped from around ₹ 50 crores to ₹10 crores. Further, a major part of its livestock was also wiped off during bird flu. She is not optimistic about the going concern assumption followed by management.

The management now wants to start with new batches of birds. The earlier working capital facilities of the company granted by bank have also been restructured to support the business. She was informed that the repayments of restructured working capital term loans are to begin from ensuing year. No fresh credit facilities have been granted by the bank. The company also plans longer credits from animal feed suppliers.

The company plans to take additional measures to prevent the safety of live stocks, including aggressive vaccination, preventive health check-ups, and more frequent visits of veterinary staff.

The villagers in surrounding areas have accused the company of spreading air pollution.

The management has prepared a cash flow forecast for her examination. Discuss the approach to be adopted by her in examining the "going concern" assumption keeping in view above with specific reference to cash flow forecast.

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TEST YOUR UNDERSTANDING 4

CA Sooraj finds that key financial ratios of a company, like current ratio, debt-service coverage ratio, inventory turnover ratio, and trade receivables turnover ratio, are in red and have deteriorated considerably as compared to last year. The company is also not able to pay to its creditors on time. The company is requesting time and again to its bankers to grant additional credit facilities, but bankers are not listening.

There have been significant losses to the company due to the lack of response of the company's products in the market. As a result of it, many products are sold at below cost price. There have been situations where the company is not able to pay the salaries of staff on time.

All these negative findings have led him to conclude that the use of going concern as the basis of accounting is not appropriate. He brings this matter to the knowledge of CFO of the company. What is reporting duty cast upon him in such a scenario?

The CFO informs him that the management, in turn, is ready to include in the disclosures the inappropriateness of its use of going concern assumption of accounting.

How should it impact the auditor's opinion in case management itself discloses the inappropriateness of its use of going concern assumption of accounting now?



3. SA 580 WRITTEN REPRESENTATIONS

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

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

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SA 580- " Written Representations"

Scope of the SA	Objectives of the auditor	Written Representation as Audit Evidence	Date & Periods covered by Written Representation	Important points to be considered
This SA deals with the auditor's responsibility to obtain written representation from management and, where appropriate, those charged with governance.	1. To obtain written representation from the management or TCWG that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor. 2. To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations. 3. To respond appropriately to written representation provided by management/ TCWG.	Although Written Representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own.	The date of Written Representation shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. Written Representation shall be for all financial statements and periods referred to in the auditor's report.	**Doubts as to reliability of Written Representations:** If written representations are inconsistent with other audit evidence, auditor shall perform audit procedures to resolve the matter. If the auditor concludes that the written representation are not reliable, the auditor shall take appropriate action in accordance with SA 705. **Requested Written Representation not provided:** Auditor shall discuss with the management, re-evaluate the integrity of management, take appropriate actions including the impact on audit report as per SA 705.

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TEST YOUR UNDERSTANDING 5

Following is a written representation given by RES Limited to its statutory auditors i.e. M/s CTK & Associates for audit of financial year 2023-24. The audit was completed and report dated 31-07-2024 was issued.

Point out, if there is any, anomaly in written representation reproduced below:

15th April, 2024

To

CTK & Associates

Chartered Accountants

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of RES Limited for the year ended March 31, 2024 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view in accordance with the applicable accounting standards in India.

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

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated 17th August 2023 for the preparation of the financial statements in accordance with financial reporting Standards, in particular, the financial statements give a true and fair view in accordance with the applicable accounting standards in India.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of applicable accounting standards in India. (SA 550)
- All events subsequent to the date of the financial statements and for which applicable accounting standards in India require adjustment or disclosure have been adjusted or disclosed. (SA 560)

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- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (SA 450)

Information provided

- We have provided you with: -
  - Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
  - Additional information that you have requested from us for the purpose of the audit; and
  - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves: -
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements.
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (SA 550)

Chief Financial Officer

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Case Scenario 1

CA Sneha, a partner in M/s J & Associates, is carrying out a statutory audit of M/s ABC Stores Ltd. for the Financial Year 2023-24, and she is ready to sign her audit report on 01.07.2024. There are some written representations which are pending with the management of the company pertaining to such an audit, and she sent Deepak (her articled trainee), who is also a member of the engagement team, to the company's office for collection of the same.

On returning back, Deepak tells CA Sneha that major stocks of the company got destroyed because of a fire in their plant on 27.06.2024, and it has affected the company's operations badly. However, the business operations are likely to be resumed by management at an alternate place.

CA Sneha postponed the issuance of the audit report to consider the impact of such an event on the financial state of affairs of the company. She wants the management to disclose the impact of this unfortunate event in financial statements for the year 2023-24, to which management is disinclined. After the management's refusal, she issued her audit report on 15.07.2024.

The management of the company seeks an appointment from CA Sneha to discuss an important matter on 20.07.2024. They informed her that the company had lost a lawsuit filed against it by one of the creditors on 18.07.2024 in a fast-track court, and now the company has to pay the plaintiff a huge amount of ₹ 2 crores. The events causing this lawsuit arose after 31.03.2024.

CA Sneha is a bit perplexed, and her first question to the people from management visiting her office was whether audited financial statements have been made available to any third parties or filed with the regulator. The management responded negatively.

Now, CA Sneha wants them to amend the financial statements to include the impact of this lawsuit on the financial affairs of the company. This time, they agreed and amended the financial statements accordingly to cover the impact of both the events – that of the fire in the plant and losing the lawsuit, but they requested CA Sneha to issue a new audit report against the earlier one dated 15.7.2024.

The management amends the financial statements, which are finally approved on 25.7.2024. CA Sneha issues a new audit report.

Considering the above situation, answer the following questions: -

1. What would be the appropriate date of signing of the new audit report?

(a) 20.07.2024

(b) Anytime between 15.07.2024 & 18.07.2024

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(c) On or after 25.07.2024

(d) Anytime between 15.07.2024 & 25.07.2024

2. CA Sneha would have taken into account a lot of procedures to get knowledge of the events occurring after the balance sheet date up to the date of the audit report relating to the company. Which of the following does not fall under such audit procedures as per SA 560?

(a) Obtaining an understanding of the management's procedures set up to identify subsequent events.

(b) Inquiring of the management w.r.t the occurrence of any such subsequent events.

(c) Reading the minutes of the meetings of the board held after the balance sheet date during this period.

(d) Getting the Interim financial statements prepared till the date of the audit report mandatorily as a condition to issue the audit report

3. W.r.t the first audit report dated 15.07.2024, which type of opinion was most likely provided by her?

(a) Modified opinion

(b) Unqualified opinion

(c) Disclaimer of opinion

(d) Including a statement in Emphasis of Matter/Other matters para

4. W.r.t the new audit report issued, which type of opinion is most appropriate?

(a) Disclaimer of opinion

(b) Unqualified opinion

(c) Adverse opinion

(d) Unqualified opinion and a statement in Emphasis of Matter/Other matters para.

5. The fire event occurring on 27.6.2024 in the company's plant requires the following action on part of management: -

(a) Disclosure in notes to accounts

(b) Adjustment in financial statements

(c) Waiting for the insurance company to settle the claim

(d) Preparing financial statements afresh

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Answers to Integrated Case Scenario 1

1. (c) **2.** (d) **3.** (a) **4.** (d) **5.** (a)

Case Scenario 2

CA Namit, a partner in M/s J & Associates, is carrying out a statutory audit of M/s XYZ Gears Ltd. for the Financial Year 2023-24 and is in the process of issuing an audit report. His articled trainee, Manpreet, is very curious about knowing the various facts relating to the consideration of Standards on Auditing while carrying out an audit and issuing the audit report.

She asks CA Namit about the relevance of the Going concern assumption in their audit and further reporting to which CA Namit explains to her that both parties have got their own responsibilities w.r.t this accounting assumption. The management of the company has its own set of responsibilities while reporting upon the same is a very strict and sensitive matter for the auditor as per the requirement of the relevant standard on auditing.

He tells Manpreet to prepare a list of procedures as she thinks that an auditor should carry out when he identifies that the company is facing a downfall in business never seen before due to newer technology in the market and other competitors having sprung up swiftly adopting new technology.

He finds that this condition may cast significant doubt on the company's ability to continue as a going concern.

Manpreet thinks and researches and hands over a list of audit procedures to CA Namit for a final discussion. CA Namit clarifies accordingly. CA Namit concludes that the use of a going concern basis of accounting is appropriate in this company's case, but a material uncertainty exists as to the future prospects of the current business. However, the management has made an appropriate disclosure w.r.t such material uncertainty in the financial statements.

Manpreet's list of audit procedures includes: -

(I) Requesting management to make its assessment relating to the company's ability to continue as a going concern.

(II) Evaluating management's plan of future actions.

(III) Make a specific assessment of the company's ability to continue as a going concern.

(IV) Analysing the cashflow forecast of the company.

(V) Considering the additional facts or information available from the date of management's assessment.

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(VI) Make appropriate disclosures in the financial statements in connection with going concerns.

(VII) Requesting Written Representation from management regarding the plans for future actions and the feasibility of these plans.

(VIII) Writing a para addressed to the stakeholders in the audit report citing the results of procedures adhered to relating to the going concern assumption.

Keeping in view above, answer the following questions: -

1. CA Namit tells Manpreet about the auditor's responsibilities in the above case on the matter under discussion. Which of the following doesn't fall under the auditor's responsibilities?

(a) Obtaining sufficient and appropriate audit evidence on the matter under discussion.

(b) Conclude on the appropriateness of the management's use of going concern.

(c) Assessing whether a material uncertainty exists about the company's ability to continue as a going concern.

(d) Guarantee the company's ability to continue as a going concern based upon his audit procedures.

2. Identify which set of audit procedures are relevant in the above case scenario as per the list prepared by Manpreet.

(a) (I), (II), (IV), (V) & (VII)

(b) (I), (III) & (V)

(c) (II), (IV), (VI), (VII) & (VIII).

(d) (I), (II), (III), (IV) & (V).

3. CA Namit's conclusion in the above case will lead him to give which type of audit opinion from the following?

(I) Modified opinion

(II) Unmodified opinion.

(III) A separate section "Material uncertainty w.r.t Going concern" in his audit report.

(a) (I) only

(b) (II) only

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(c) (I) & (III)

(d) (II) & (III)

4. Consider the following statements: -

Statement I: - The Management is under a responsibility to make specific assessment of the company's ability to continue as a going concern.

Statement II:-. The Management is under a responsibility to make appropriate disclosures in connection with going concern in the financial statements.

(a) Statement I is correct only.

(b) Statement II is correct only as Statement I falls under the auditor's responsibilities.

(c) Both statements are correct.

(d) Both statements are incorrect.

5. Which of the following is most appropriate regarding "going concern" assumption?

(a) It signifies that company is reflecting net losses in its financial statements.

(b) It signifies that company is not modernising its plant and machinery.

(c) It signifies that company has no intention of curtailing materially the scale of its operations in foreseeable future.

(d) It signifies that assets are likely to be recorded at the prices they would fetch.

Answers to Integrated Case Scenario 2

1. (d) **2.** (a) **3.** (d) **4.** (c) **5.** (c)

Case Study

Infinity Hospitality Private Limited was established in 1996 and was in the business of running hotels in tourist destinations in state of Kerala. It took leased properties on long-term leases ranging from 10 to 12 years, most with a lock-in of a whole term. The terms did not cover the *force majeure clause.* The company was family-owned business and had created a good reputation as value for a money-budget hotel. Most of the time, hotels clocked 60 to 75% occupancy rate, and during the festive season/ vacations, hotel business clocked 100% Occupancy.

The capital structure of the company was debt oriented and over-leveraged.

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Primary working capital was blocked in maintaining and upkeeping the leased properties, running the restaurant, leases, food and beverages, salary, Director's remuneration etc.

The owners looked at the business as a cash cow and did not plough back the funds to expand the business but were content with the decent profits the hotels were generating.

As the properties were leased and not owned, most of the cash flow generated from operations was used in servicing the property and huge loans from financial institutions. What was left was withdrawn as Directors' remuneration and dividend.

Everything was going on smoothly. However, there were flash floods in Kerala due to unprecedented rains. There were landslides and roads were blocked. The entire tourist season was washed away due to infrastructural challenges. Accessibility to resorts and hotels was badly hindered. Logistics support took time to reach in far flung areas. Visit to the *"The God's own country"* was last on the mind of tourists. The company was hardly trying to get back to some semblance of normalcy when pandemic struck. It was double whammy for the company.

The impact on travel, tourism and hospitality business was very severe. The management of Infinity Hospitality Private Limited believed that bad days would end soon and the business would be back to normal. They also were optimistic about the government coming up with support for the industry and were hopeful of negotiating with lessors and Financial Institutions for relief. They decided on humanitarian grounds not to terminate the employees and continued paying them a regular salary, maybe deferring 25% to be paid after one year. The immediate fallout was on the top line as suddenly, the business stopped.

The auditors, M/s XYZ and Associates, were conducting the audit of the company and were grappling with the situation and are seeking your guidance for the course of action they need to follow.

Theoretical Questions

Based on the case scenario, you are required to provide your answers to the following:-

1. *What additional audit procedures must the auditor undertake as per requirements of SA 570 based on the facts given in the case?*

2. *According to your judgment, what risk assessment procedures should the auditor consider for arriving at a conclusion based on the management assertion of the entity being Going Concern?*

3. *What should be approach of the auditor if the management agrees that the material uncertainly exists, but the entity is a Going Concern? Also discuss reporting requirements.*

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4. *What if the auditor believes, on the basis of his additional audit procedures conducted to conclude that the entity is not a Going Concern, but the management is not accepting the same? What course of action the auditor needs to undertake?*

5. *What kind of written representation does the auditor need to obtain in case of the scenario covered in Q3 above?*

Multiple Choice Questions

1. *Which of the following is not a financial event/ condition that may cast significant doubt on companies ability to continue as a going concern as per SA 570?*

(a) Change from credit to cash on delivery model with suppliers

(b) Arrears or discontinuance of dividend

(c) Opening of a new chain of hotels by renowned competitor near the entity's area

(d) Adverse key financial ratios

2. *Please choose the mitigating measure as the management is unable to pay lease rentals.*

(a) Cancel the lease

(b) Restructure the lease agreement and negotiate for deferment and relief

(c) Terminate the employees and pay the lessor

(d) All the above

3. *Which one of the following is not a responsibility of the auditor relating to communicating events or conditions identified that may cast significant doubt on the entity's Going Concern assertion?*

(a) Perform additional audit procedures to identify events/ conditions beyond 12 months from the date of financial statements

(b) Whether the events constitute a material uncertainty

(c) The adequacy of related discloses in the financial statements

(d) The implications for the auditor's report

4. *Written Representation need to be mandatorily obtained from:*

(a) Audit Committee

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(b) *Client relationship Managers*

(c) *Company Secretary*

(d) *CFO*

5. *Which of the following is not main pillar of written representations?*

(a) *The management responsibility for preparation of financial statement*

(b) *Assertion related to completeness*

(c) *Assertion related to access to data and information*

(d) *Written representation provides sufficient appropriate audit evidence*

Answers to Theoretical Questions

1. In the given case scenario the events and conditions have been identified which cast significant doubt on the entity's ability to continue as a Going Concern, the auditor needs to obtain sufficient appropriate audit evidence to determine whether or not material uncertainty and gather evidence including of mitigating factors. It can be done by performing following additional procedures: -

- Analysing and discussing cash flow, profit and other relevant forecast with management.
- Analysing and discussing the entity's latest available interim financial statement.
- Reading the terms of loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their out come and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third party and assessing the financial ability of such parties to provide additional funds.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

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- Confirming the existence, terms and adequacy of borrowing facilities.
- Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
- Evaluating management's plans for further actions in relation to its going concern assessment, whether the outcome of these plan is likely to improve the situation and whether the management's plans are feasible in the circumstances.
- Evaluating management's plans for future actions may include inquiries of management as to its plan for future action, including, for example, its plan to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.
- Considering whether any additional facts or information have become available since the date on which management made it assessment.
- Requesting written representation from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

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

- The auditor shall discuss the assessment with management and determine whether management has identified events and conditions that, individually or collectively, cast significant doubt on the entity's ability to continue as a going concern and if so, management's plan to address them.
- The auditor shall specifically draw attention of Management on following events or condition and get the response on how they plan to address them:

The company is debt heavy and over leveraged. The leased properties are having considerable lock-in period with absence of force majeure clause. There are no contingency reserves available with company. All these factors shall be taken into account while performing risk assessment procedures.

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

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

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

(c) The disclosures may include:

i. Management's evaluation of the significance of the events or conditions relating to the entity's ability to meet its obligations; or

ii. Significant judgements made by management as a part of its assessment of the entity's ability to continue as a going concern

iii. Disclosures about the magnitude of the potential impact of the principal events or conditions, and the likelihood and timing of the occurrence.

iv. The auditor shall express and unmodified opinion and the auditor’s reports shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

- Draw attention to the note in the financial statement that discloses the events or conditions and
- State that these events are conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and the auditor's opinion is not modified in respect of the matter and how the matter was addressed in the audit.

4. If management has prepared financial statements using the Going Concern assertion to which auditor differs as according to his judgement, the Going Concern assertion by the management is not appropriate, then the auditor is required to express an adverse opinion.

5. The auditor needs to obtain written representation from management and where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

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Answers to Multiple Choice Questions

1. (c) **2.** (b) **3.** (a) **4.** (d) **5.** (d)

Key Takeaways

- Events occurring between the date of the financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report are known as subsequent events.
- Such events may be those that provide evidence of conditions that existed at the date of the financial statements and those that provide evidence of conditions that arose after the date of the financial statements.
- SA 560 deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.
- The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
- Going concern is one of the fundamental accounting assumptions. The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.
- SA 570 Going Concern deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.
- The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of management's use of the going concern basis of accounting.
- If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors.
- A written representation is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this

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context do not include financial statements, the assertions therein, or supporting books and records.

- Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.
- SA 580 Written representations deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM: SCAN ME !

Note: Content of SA 560 -Subsequent Event; SA 570- Going Concern and SA 580- Written Representation is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Ramadhan & Co. are the auditors of XYZ Company Ltd. for the year ended on 31/03/2024. The Audit Report for that year was signed by Ramadhan & Co. on 04/05/2024. The Annual General Meeting was decided to be held during the month of August 2024. On 06/05/2024, the Company had received a communication from the Central Government that an amount of ₹ 5800 crore kept pending on account of incentives pertaining to Financial Year 2023-24 had been approved and the amount would be paid to the Company before the end of May 2024. To a query to Chief Financial officer of the Company by the Board, it was informed that this amount had not been recognised in the Audited Financial Statements in view of the same not being released before the close of the Financial Year and due to*

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uncertainty of receipt. Now, having received the amount, the Board of Directors wished to include this amount in the Financial Statements of the Company for the Financial Year ended on 31/03/2024. On 08/05/2024, the Board amended the accounts, approved the same and requested the Auditor to consider this event and issue a fresh audit report on the Financial Statements for the year ended on 31/03/2024. Analyse the issues involved and give your views as to whether or not the Auditors could accede to the request of the Board of Directors.

2. *M/s Airlift Ltd., carrying on the business of passenger transportation by air, is running into continuous financial losses as well as reduction in sales due to stiff competition and frequent break down of its own aircrafts. The Financial Statements for the Year ended on 31/03/2024 are to be now finalized. The Management is quite uncertain as to its ability to continue in near future and has informed the Auditors that having seized of this matter, it had constituted a committee to study this aspect and to give suggestions for recovery, if any, from this bad situation. Till the study is completed, according to the Management, the issue involves uncertainty as to its ability to continue its business and it informs the Auditor that the fact of uncertainty clamping on the "Going Concern" would suitably be disclosed in notes to accounts. State the reporting requirement if any, in the Independent Auditor's Report in respect of this matter.*

3. *PRSH & Co is the statutory auditor of Make My Journey Ltd. The company is in the business of tours and travels. The annual turnover of the company is ₹ 2000 crores and profits are ₹ 190 crores. During the planning meeting of the management and the auditors, it was discussed that the management needs to provide written representation letter to the auditors for the preparation of the financial statements and for the completeness of the information provided to the auditor. At the time of closure of the audit, there has been some confusion about the requirements of the written representation letter. Management argued that representation need not be written, it can also be verbal which has been provided to the audit team during the course of their audit. Auditors have completed their documentation and hence in a way, representation based on verbal discussions with the auditors has also got documented. Auditors explained that this is mandatory to obtain written representation in accordance with the requirements of SA 580. However, still some confusion remains regarding the date and period covered by the written representation. You are required to advise about the date of, and period covered by written representation in view of SA 580.*

4. ***CA Shobit is conducting an audit of XYZ Ltd. for the year 2023-24. The company is engaged in the export of handicraft items in Europe. The audit is nearing completion in the month of July 2024. However, it becomes known to CA Shobit that one of***

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overseas buyers has made a legal claim against the company on 1st June 2024 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August 2023. The management of the company has decided to agree to an out of court settlement of ` 4 crore to protect its reputation. The financial statements of the company are silent on this issue. Discuss, how, CA Shobit should proceed to deal with above issue.

5. *CA N is carrying out an audit of restated financial statements of BQR Limited for past 3 financial years i.e. 2023-24, 2022-23 and 2021-22 for onward submission to SEBI pursuant to their upcoming IPO (Initial Public Offer). CA N is planning to issue an Audit Report on 5th August, 2024 covering these restated financial statements. Before issuing the audit report, CA N requested Management Representation Letter from the management of the Company for this assignment. The Management of the Company provided Management Representation Letter dated 1st April, 2024 covering the period of financial year 2023-24 only as they were not in position to provide for the financial year 2022-23 and 2021-22 because they were not in place during that period.*

   How would CA N deal with the above situation as per relevant Standard on Auditing?

6. *Mudit & Associates is appointed as Statutory Auditors of GRF Private Limited for the financial year 2023-24. The company is into the business of Health Club, Fitness Centre and gym costumes. CA M is the Engagement Partner for the audit assignment. CA M observed the following points while auditing:*

   (i) Customer's base is reducing continuously due to tough competition and discount war existing in the market.

   (ii) Payments of creditors are delayed and made with overdue interest.

   (iii) Company has not been able to pay the salaries of staff and trainers on time.

   (iv) Key financial ratios of the company, like current ratio, debt-service coverage ratio, are in the red and have deteriorated considerably as compared to last year.

   (v) The company has requested its bankers to provide it with additional working capital credit facilities of ` 1.5 Crores, but bankers are not considering the company's proposal favorably.

   What audit procedures should be followed by CA M considering the above circumstances as per SA 570 - "Going Concern"? How auditor should deal if the use

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of going concern basis of accounting is appropriate, but a material uncertainty exists, and adequate disclosure of material uncertainty is made in the financial statements?

7. ***The audit report of Rare (P) Ltd for F.Y. 2023-24 was issued by SRM & Co. on 23rd July, 2024. However, a case was filed against Rare (P) Ltd on 9th August, 2024, with the Civil Court, with respect to an incident caused in its factory on 24th January, 2024, the future outcome of which may result into paying heavy penalty by Rare (P) Ltd, which was informed to Mr. Rishabh Pandey, the partner of SRM & Co.***

Mr. Rishabh discussed the said matter with the management, and it was determined to amend the financial statements for F.Y. 2023-24. Further, Mr. Rishabh inquired how the management intended to address the said matter in the financial statements to which he was told that the said matter was going to be disclosed as a "Contingent Liability for a Court case" to the foot note in the balance sheet with no additional disclosures.

The management told Mr. Rishabh that such disclosure was enough as he would be further going to provide description of the said court case and its outcome in the 'Emphasis of Matter' paragraph in his amended audit report.

In the context of aforesaid case-scenario, please answer to the following questions: -

(i) Whether Mr. Rishabh on behalf of SRM & Co., has properly adhered to his responsibilities in accordance with SA 560, on becoming aware of the court case filed against Rare (P) Ltd?

(ii) Whether the contention of management of Rare (P) Ltd is valid with respect to the disclosure of court case in the financial statements?

Answers to Test your Understanding

1. The given situation provides evidence of conditions that existed at the date of financial statements. Initially, the company had lodged claim of ₹1 crore and the same is reflected as claim receivable in financial statements as on 31st March, 2024.

However, subsequent events occurring have provided evidence that claim was settled for ₹ 45 lacs only. Such a settled amount has already been accepted by the company by providing its consent. Therefore, such events have provided fresh information about items included in financial statements.

Further, the performance of substantive procedures has been finished implying that the audit report is not yet issued.

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Therefore, financial statements as on 31st March, 2024 should be adjusted to reflect fresh information emanating from described events and management should be asked to take appropriate action in this regard so that adjustment pertaining to above is properly reflected in financial statements in accordance with applicable financial reporting framework.

2. In the given situation, dividend has been proposed by Board of Directors on 17th April, 2024. It is an example of conditions that arose after the reporting period. No liability exists for the company on the reporting date because there is no obligation to pay at the reporting date in accordance with Ind AS 1.

Therefore, the above situation does not require recognition of the above proposed dividend in financial statements. It is an example of events which do not require adjustments. However, it should be disclosed in financial statements in notes to accounts. Therefore, it should be ensured that it is disclosed in notes to accounts in financial statements. He should verify in accordance with SA 560 that it is disclosed in notes to accounts.

3. In accordance with SA 570,"Going Concern", if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern by performing additional audit procedures, including consideration of mitigating factors.

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

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

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

In the above situation, cash flow forecast has been prepared by management. Therefore, she should carefully evaluate assumptions underlying forecast and also reliability of data to prepare the forecast. For example: -

- She should verify assumption regarding fresh batch of livestock. The bankers have not provided fresh credit facilities. How funds from the same would be arranged? The reasonability of assumption in cash flow forecast needs to be looked into.

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- She needs to check loan sanction letters/agreement to verify when repayments are beginning to see their accuracy in cash flow forecasts.
- The company plans to avail longer credits from animal feed suppliers. In the downturn situation of the company, how would suppliers extend longer credits? This is going to have effect on the cash flow forecast.
- Whether company has accounted for increased expenditure on preventive health check-up, vaccination and more frequent visits of veterinary staff in cash flow forecast.
- Since villagers have accused the company of spreading air pollution, how does the company plan to deal with the same? Whether any proposed expenditure in this regard is accounted for in the cash flow statement. She may also consider other implications of this issue and possible effect on cash flows.

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

The requirement for an auditor to express an adverse opinion applies regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern basis of accounting.

Therefore, even if management discloses that its use of going concern assumption of accounting is inappropriate, it would have no impact on auditor's opinion. He would need to express adverse opinion.

5. The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. As the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In the given situation, written representation is dated 15th April 2024. The audit report is dated 31st July 2024. There is a considerable lag between date of written representations and date of audit report.

It could signify that all subsequent events after date of financial statements requiring adjustments or disclosure may not have been adjusted or disclosed in the financial statements by management.

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As audit report is dated 31St July, 2024, it reflects that auditor has considered subsequent events occurring between date of financial statements and date of auditor's report. However, written representations pertain to 15th April 2024.

Hints /Answers to Theoretical Questions

1. **Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued:** As per SA 560, "Subsequent Events", the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall

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

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

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

   If management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment. Further, the auditor shall extend the audit procedures and provide a new auditor's report on the amended financial statements. However, the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

   In the instant case, XYZ Company Ltd. received an amount of ₹5800 crore on account of incentives pertaining to the year 2023-24 in the month of May 2024 i.e. after finalisation of financial statements and signing of audit report. The Board of Directors of XYZ Ltd. amended the accounts, approved the same and requested Ramadhan & Co. (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31-03-2024.

   After applying the conditions given in SA 560, Ramadhan & Co. can issue new audit report subject to date of audit report which should not be earlier than the date of approval of the amended financial statements.

2. **Reporting requirements in case of Uncertainty clamping on the Going Concern:** As per SA 570 "Going Concern", if the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty

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exists, the auditor shall determine whether the financial statements : (i)adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and (ii) disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

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

(i) Draw attention to the note in the financial statements that discloses the matters set out above; and

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

In the instant case, M/s Aircraft Ltd. is running into continuous financial losses as well as reduction in sales due to stiff competition and frequent break down of its own aircrafts and management of Aircraft Ltd. is uncertain as of its ability to continue in near future. Therefore, a committee has been constituted to study this aspect and till the time study is completed management accordingly decided to suitable disclose this aspect in notes to accounts. Therefore, the auditor should disclose about the material uncertainty and express an unmodified opinion and in his audit report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to draw attention to the note in the financial statements that discloses the matters set out above; and state that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

3. As per SA 580, "Written Representations", as written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated

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as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

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

4. ***In the given case, the auditor has come to know the legal claim against the company before the issuance of the audit report. It has also come to his knowledge that the management of the company has agreed to an out of court settlement of ₹ 4 crore.***

This is an example of a subsequent event between the date of the financial statements and the date of the auditor's report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements.

Further as per SA 560, "Subsequent Events", the auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all the events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

CA Shobit should ensure that appropriate adjustments and disclosures are made by the management. In the absence of the same, he should consider the impact of the said event and report accordingly.

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5. *In the given situation, CA N is carrying out an audit of restated financial statements of BQR Limited for past 3 financial years i.e., 2023-24, 2022-23 and 2021-22 so he requested Management Representation Letter from the management of the Company for this assignment before issuance of the report. The management of the Company provided the Management Representation Letter only for the financial year 2023-24 as they were not in place during that period.*

As per SA 580, "Written Representations", as written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated before the date of the written representations.

As per SA 560, "Subsequent Events", the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

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

Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies. Therefore, as per the above requirement of SA 580 CA N should take written representation letter from management of BQR Limited for the financial year 2022-23 and 2021-22 also.

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In case the management of BQR Limited does not provide written representation as requested, the auditor shall discuss with the management, re-evaluate the integrity of management, and take appropriate actions including the impact on the audit report as per SA 705.

6. *As per SA 570, "Going Concern", if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:*

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

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

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

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

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

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

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

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In the given case, CA M has observed such points that may cast significant doubt on the entity's ability to continue as a going concern. Therefore, CA M should follow audit procedures such as:

- *Review of management's assessment of the company's ability to continue as a going concern.*
- *Examine and challenge the reasonableness of the company's cash flow forecasts and key assumptions.*
- *Review events after the reporting period that might affect the going concern assumption, such as further financial deterioration or inability to secure financing.*
- *Analysis of the company's key financial ratios and compliance with loan agreements to assess liquidity and solvency.*
- *Review of the company's challenges and efforts to secure additional financing and the reasons for the bank's reluctance to provide further credit.*
- *Assess the impact of declining customer base, delayed payments, and other operational challenges on the company's ability to continue as a going concern.*

Further, as per SA 570 if adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

(a) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 19; and

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

7. (i) As per SA 560, 'Subsequent Events', the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(1) Discuss the matter with management and, where appropriate, those charge

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

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

In the given case, on becoming aware of the court case filed against Rare (P) Ltd., Mr. Rishabh discussed the said matter with the management, and was determined to amend the financial statements. Also, he inquired how the management intended to address the said matter in the financial statements.

Thus, it can be said that Mr. Rishabh has properly adhered to his responsibilities in accordance with SA 560, on becoming aware of the court case filed against Rare (P) Ltd.

(ii) As per SA 706, 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report', an Emphasis of Matter paragraph is not a substitute for:

(a) A modified opinion in accordance with SA 705 (Revised) when required by the circumstances of a specific audit engagement;

(b) Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or

(c) Reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

In the given case, the management of Rare (P) Ltd. has presumed that as the auditor was going to provide a description of the said court case and its outcome in the 'Emphasis of Matter' paragraph in his amended audit report, there was no further need for it to provide additional disclosures about the court case in the financial statements.

The said contention of management of Rare (P) Ltd. is not valid as 'Emphasis of Matter' paragraph cannot be used as a substitute for disclosures required to be made in the financial statements as per the applicable financial reporting framework or that is otherwise necessary to achieve fair presentation, which is the responsibility of the management.

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CHAPTER 7

REPORTING



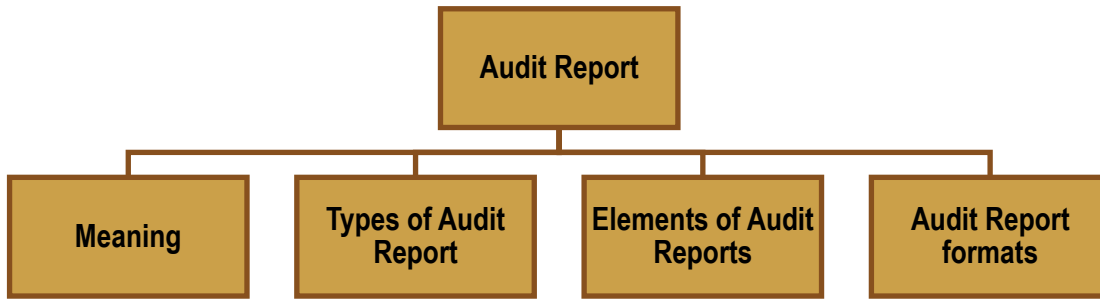
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the Reporting requirements and Different types of Unmodified and Modified Audit Reports as per Standards of Auditing.
- Identify the different aspects of Reporting as per Standards of Auditing.
- Determine and apply knowledge of Reporting for further study and Professional Practice.

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CHAPTER OVERVIEW



CA A got an invitation to attend a seminar on *"Audit Conclusions and Reporting-Responsibilities of auditors"* in context of SA 700 series organized by local branch of WIRC of ICAI. Realizing the importance of the topic in context of heightened regulatory glare being continuously highlighted in media, he made it sure to attend the seminar. Eminent speakers brought out how significant it is to prepare an audit report in accordance with Standards on Auditing. Audit report is the document by means of which an auditor expresses opinion. Its significance, in the context of an audit, is paramount.

Discussing threadbare such issues, one learned speaker underlined need for 'expression of appropriate opinion" by auditors in view of rapid changes in business environment. If a modified opinion is warranted in accordance with SA 705, such an opinion must be expressed by auditors clearly explaining the basis for such opinion. In case evidence points to misstatements impact of which is both material and pervasive, auditors should not hesitate to express adverse opinion in audit reports.

It was also made loud and clear that auditors should try to challenge matters such as key underlying assumptions. These should not be meekly accepted by the auditors as these have significant implications for audit report.

It was tried to be explained in context of "Going concern" assumption. Auditors should go all out to see that its use is appropriate in the preparation of financial statements by the client by going through client's assessment. If client has not made its assessment, auditor should quiz management regarding justification of it following such an assumption.

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Such matters have immediate and direct implications for the auditor's report. Like, if in auditor's judgment, use of going concern basis of accounting is inappropriate, adverse opinion needs to be expressed. Raising an alarm, it was clearly transmitted that such matters were too crucial to be taken lightly.

Accentuating value of Emphasis of Matter paragraphs, it was shared by another speaker how to use such paragraphs in audit reports. One fundamental requirement of using such a para in accordance with SA 706 is that such paragraph cannot be used in respect of matters for which modification of opinion is required. These paras are no substitute for modified opinion.

Underscoring increase in communicative value of audit reports by highlighting key audit matters identified during the course of audit, it was hammered that not only such matters are stated in accordance with SA 701, manner of addressing such matters by performing audit procedures is also stated in audit reports.

1. INTRODUCTION





Assuming you are an auditor and have concluded the audit field work, your next step will be issuance of the audit report. Issuance of Audit report is the culmination of the Audit Work. It is the most important deliverable for a Statutory Auditor. An audit report is very important medium of communication i.e. auditor's expert views on the financial statements and it has a significant bearing on the credibility of the Financial Statements. By expressing an opinion in the audit report, the auditor takes upon himself a great responsibility because a large number of stakeholders are likely to place reliance on the financial statements and are dependent on the Auditors Opinion on the financial statements. Therefore, the auditor is necessarily required to be careful, vigilant, and objective in the matter of preparation of his report. The auditor should endeavor to keep his report in accordance with the reporting requirements mandated by the Standards on Auditing to bring about uniformity in the issuance of Audit Opinion.

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2. THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

The SA 700 series is purely dedicated to the auditor's report to be issued by the auditor. There are following SAs which you need to be aware of:

Particulars	Head	Purpose
SA-700	Forming an Opinion and Reporting on Financial Statements	• Forming an opinion on the financial statements. • Form and content of the auditor's report. • Deals with Un-Modified (Clean) opinion of the Auditor.
SA-701	Communicating Key Audit Matters in the Independent Auditor's Report	• To enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. • To assist the user in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.
SA-705	Modifications to the Opinion in the Independent Auditor's Report	• To issue an appropriate auditor's report when the auditor considers the modification of the audit opinion in the report is necessary. • To deal with the revised form and content when the modification of the opinion takes place.
SA-706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	To draw user's attention to a matter or matters:- • Presented or disclosed in the financial statements and which is fundamental for the understanding of the user, or • Not presented or disclosed in the financial statement and which is relevant for the understanding of the user.

3. SA 700 FORMING AN OPINION AND REPORTING ON THE FINANCIAL STATEMENTS

It deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.

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Objective: As per SA 700 the objectives of the auditor are:

(a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and

(b) To express clearly that opinion through a written report.

3.1 Purpose

SA 700 applies to an audit of a complete set of general-purpose financial statements and is written in that context. The requirements of this SA are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This SA promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

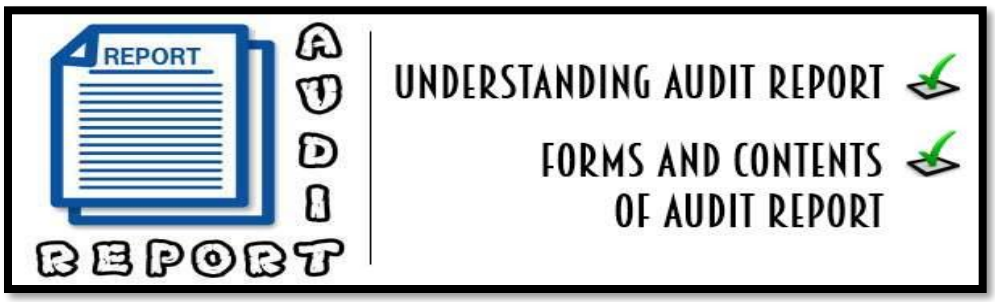


Image: Understanding Audit report, Forms and contents of Audit Report*

Forming an opinion on the Financial Statements

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. In order to form that opinion, the auditor shall obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement whether due to fraud or error. Further, when the financial

* **Source : accountlearning.com**

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statements are prepared in accordance with a fair presentation framework, the auditor shall also evaluate as to whether the financial statements achieve fair presentation by considering:

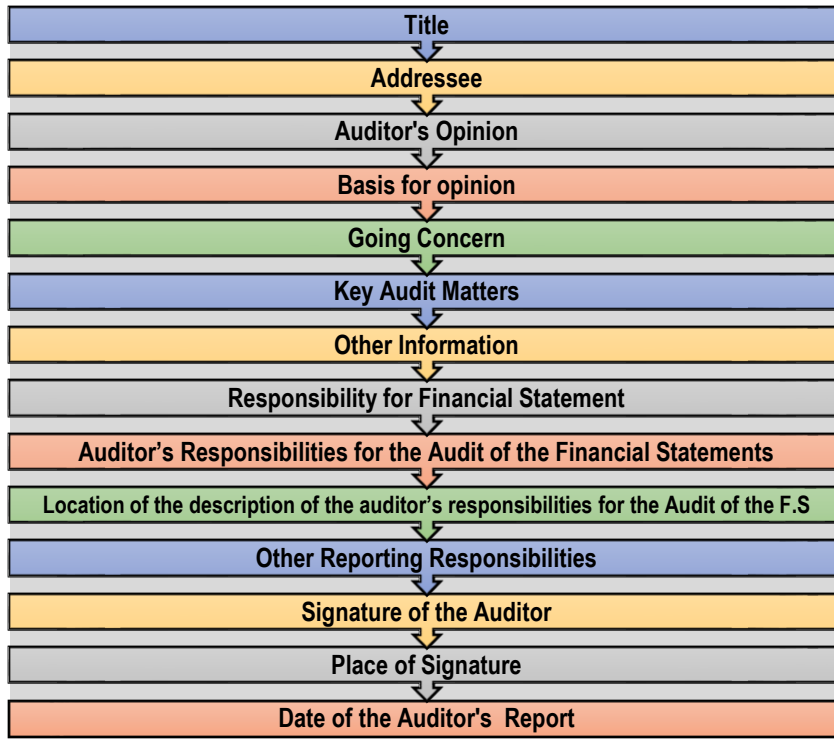
1. The overall presentation, structure and content of the financial statements; and
2. Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

In other words, the auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

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

3.2 Basic Elements of the Auditor's Report

As per SA 700, "Forming an opinion and reporting on financial statements", the auditor's report shall be in writing and shall include the following basic elements, which ordinarily includes in case of Auditors' Report for Audits Conducted in Accordance with Standards on Auditing:



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1. **Title:** The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.



1. "Independent Auditor's Report," distinguishes the independent auditor's report from reports issued by others.

2. **Addressee:** The auditor's report shall be addressed as required by the circumstances of the engagement.



2. The report could be addressed to the Members of the Company in case of general purpose (statutory) financial statements and to the Board of Directors in case of special purpose financial statements.

3. **Auditor's Opinion:** The first section of the auditor's report shall include the auditor's opinion and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

(a) Identify the entity whose financial statements have been audited;

(b) State that the financial statements have been audited;

(c) Identify the title of each statement comprising the financial statements;

(d) Refer to the notes, including the summary of significant accounting policies; and

(e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

(i) In our opinion, the accompanying financial statements present fairly, in all material respects, […] in accordance with [the applicable financial reporting framework]; or

(ii) In our opinion, the accompanying financial statements give a true and fair view of […] in accordance with [the applicable financial reporting framework].

When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the accompanying financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework].

If the reference to the applicable financial reporting framework in the auditor's opinion is not to Accounting Standards, the auditor's opinion shall identify the origin of such other framework.

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Extract of Independent Auditor's Report - Unmodified Opinion Paragraph

Opinion

We have audited the standalone financial statements of [redacted] (the "Company") which comprise the standalone balance sheet as at 31st March, 2023, and the standalone statement of profit and loss (including other comprehensive income), standalone statement of changes in equity and standalone statement of cash flows for the year ended 31st March, 2023, and notes to the standalone financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Companies Act, 2013 ("Act") in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 2023, and its profit and other comprehensive loss, changes in equity and its cash flows for the year ended on that date.

Opinion

1. We have audited the accompanying standalone financial statements of [redacted] ('the Bank'), which comprise the Balance Sheet as at 31 March 2022, the Profit and Loss Account and the Cash Flow Statement for the year then ended, and a summary of the significant accounting policies and other explanatory information.

2. In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Banking Regulation Act, 1949 as well as the Companies Act, 2013 ('the Act') and circulars and guidelines issued by the Reserve Bank of India ('the RBI'), in the manner so required for banking companies and give a true and fair view, in conformity with the Accounting Standards specified under section 133 of the Act, read with the Companies (Accounting Standards) Rules, 2021 and other accounting principles generally accepted in India, of the state of affairs of the Bank as at 31 March 2022 and its profit and its cash flows for the year ended on that date.

4. Basis for Opinion: The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

(a)	States that the audit was conducted in accordance with Standards on Auditing;
(b)	Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
(c)	Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI
(d)	States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

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Extract of Independent Auditor's Report – Basis for Unmodified Opinion Paragraph

Basis for Opinion

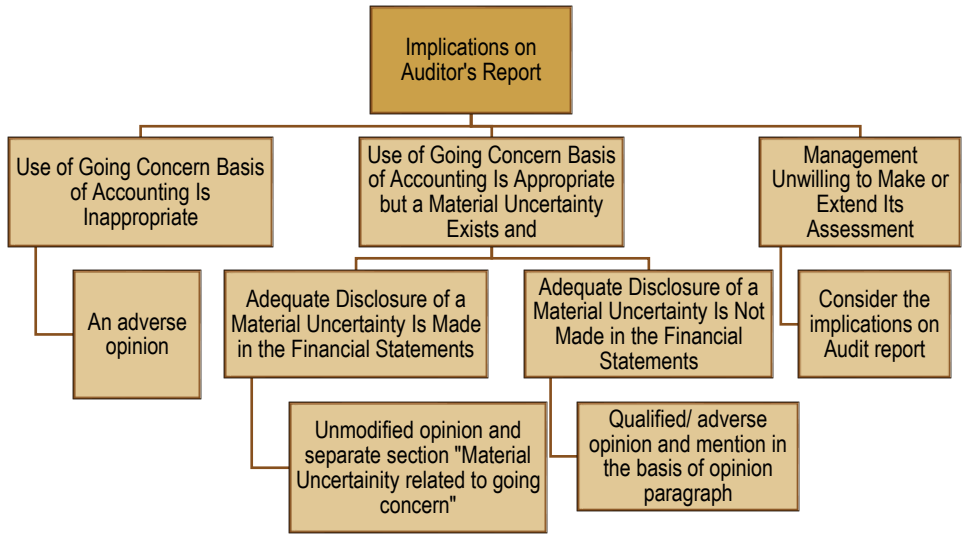
We conducted our audit in accordance with the Standards on Auditing (SAs) specified under Section 143(10) of the Act. Our responsibilities under those SAs are further described in the Auditor's Responsibilities for the Audit of the Standalone Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the standalone financial statements under the provisions of the Act and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion on the standalone financial statements.

Basis for Opinion

3. We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Act. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Standalone Financial Statements section of our report. We are independent of the Bank in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India ('ICAI') together with the ethical requirements that are relevant to our audit of the standalone financial statements under the provisions of the Act and the rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

5. **Going Concern:** Where applicable, the auditor shall report in accordance with SA 570. SA 570 deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report. The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

Implications for the Auditor's Report:



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I. Use of Going Concern Basis of Accounting is Inappropriate: If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

II. Use of Going Concern Basis of Accounting is Appropriate, but a Material Uncertainty Exists and:

(A) Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements: If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

(i) Draw attention to the note in the financial statements that discloses the matters

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

Extract of Independent Auditor's Report – Material Uncertainty related to Going Concern

Material Uncertainty related to Going Concern

1. We draw attention to Note no. 10 of the consolidated financial results wherein the auditors of [redacted] have highlighted material uncertainty related to going concern of [redacted]. However, the accounts of [redacted] has been prepared on a Going concern basis for the reasons stated in the aforesaid note.

2. The auditors of certain subsidiaries and associates as stated in Note no. 11 of the consolidated financial results have highlighted material uncertainty related to going concern / emphasis of matter paragraphs / key audit matters related to going concern in their respective audit reports.

3. We draw attention to Note No. 13 of the consolidated financial results regarding the Group's ability to meet its obligations is dependent on certain events which may or may not materialise including restructuring of loans, time bound monetization of assets and realisation of regulatory / arbitration claims. There are material uncertainties which could impact the Group's ability to continue as a going concern. However, the Group is confident of meeting its obligations in the normal course of its business and accordingly, the consolidated financial results of the Group have been prepared on a going concern basis.

Our opinion on the consolidated financial results is not modified in respect of the above matters.

(B) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements: If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

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(i) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised); and

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

(C) Management Unwilling to Make or Extend its Assessment: If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report.

Note: Where the use of Going Concern Basis is appropriate then no special paragraph is required in the Auditors Report mentioning the fact.

ILLUSTRATION 1

CA Sameer is the statutory auditor of Tram Fram Ltd. for the FY 2023-24. While concluding the audit CA Sameer decided to issue an unmodified opinion, though he also concluded that a material uncertainty exists with respect to the company's ability to continue as a going concern on account of a pending litigation related to labour laws. He is of the view that the company has made appropriate disclosures with respect to such pending litigation in the notes to accounts annexed to the financial statements of Tram Fram Ltd. for the FY 2023-24. Explain how CA Sameer will deal with the above situation in his auditor's report (draft the relevant portion of the auditor's report).

SOLUTION

Material Uncertainty Related to Going Concern

We draw attention to Note 10 in the financial statements, which indicates that the outcome of a litigation on account of labour laws is pending in case of the company during the year 31 March, 2024. As stated in Note 11, this event or condition, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

6. Key Audit Matters: For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with SA 701.

When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701.

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Definition of Key Audit Matters	Key Audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

7. **Other Information:** Where applicable, the auditor shall report in accordance with SA 720 (Revised).

8. **Responsibilities for the Financial Statements:** The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements". The auditor's report shall use the term that is appropriate in the context of the legal framework applicable to the entity and need not refer specifically to "management". In some entities, the appropriate reference may be to those charged with governance.

This section of the auditor's report shall describe management's responsibility for

(a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(b) Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfill the responsibilities described in next paragraph. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework applicable to entity.

When the financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

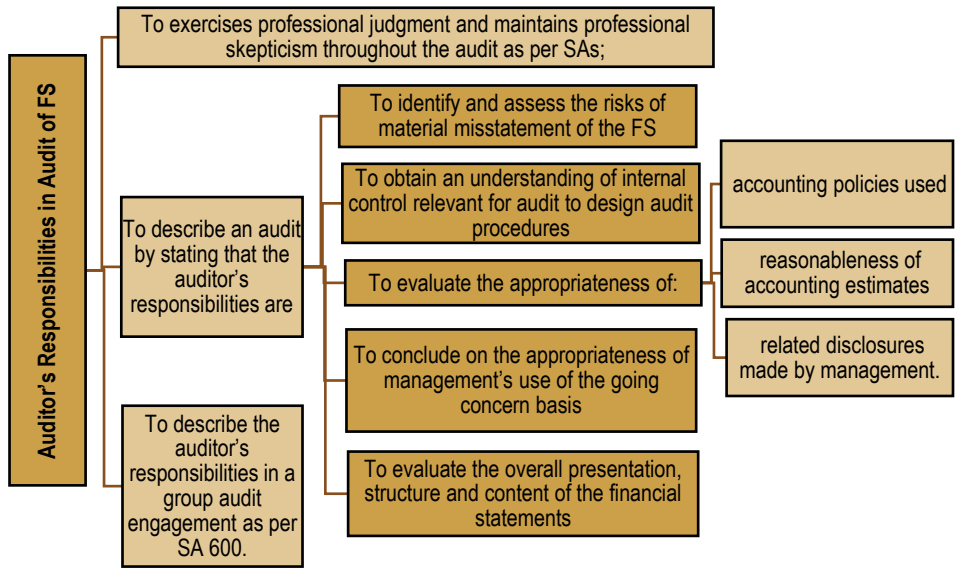
9. **Auditor's Responsibilities for the Audit of the Financial Statements:** The auditors report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."

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(I) This section of the auditor's report shall:

(a)	**State that the objectives of the auditor are to:** (i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and (ii) Issue an auditor's report that includes the auditor's opinion.
(b)	**State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and**
(c)	**State that misstatements can arise from fraud or error, and either:** (i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or (ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework.

(II) The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:



(a) State that, as part of an audit in accordance with SAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and

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(b) Describe an audit by stating that the auditor's responsibilities are:

(i) **To identify and assess the risks of material misstatement of the financial statements,** whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

(ii) **To obtain an understanding of internal control relevant to the audit in order to design audit procedures** that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

(iii) **To evaluate the appropriateness o**f accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

(iv) **To conclude on the appropriateness of management's use of the going concern basis** of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.

(v) When the financial statements are prepared in accordance with a fair presentation framework, **to evaluate the overall presentation, structure and content of the financial statements**, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

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(c) When SA 600, "Using the Work of Another Auditor", applies, further describe the auditor's responsibilities in a group audit engagement by stating, the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components is audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors

(III) The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:

(a) State that the auditor communicates with those charged with governance regarding, among other matters:

- the planned scope and timing of the audit and
- significant audit findings,
- including any significant deficiencies in internal control that the auditor identifies during the audit;

(b) State that the auditor provides those charged with governance with a statement that the auditor has:

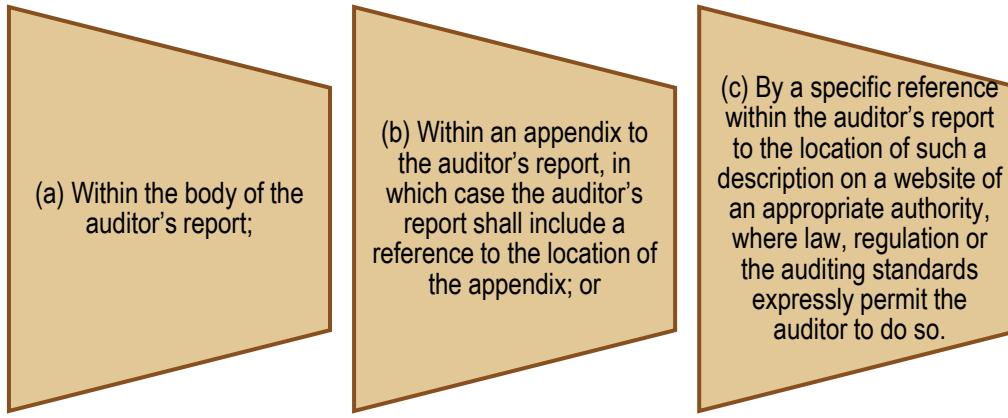
- complied with relevant ethical requirements regarding independence and
- communicate with them all relationships and
- other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and

(c) For audits of financial statements of all such entities **for which key audit matters are communicated in accordance with SA 701,** state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters.

In accordance with the requirements of SA 701, the auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

10. Location of the description of the auditor's responsibilities for the audit of the financial statements: The description of the auditor's responsibilities for the audit of the financial statements required by this SA shall be included:

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When the auditor refers to a description of the auditor's responsibilities on a website of an appropriate authority, the auditor shall determine that such description addresses, and is not inconsistent with, the requirements of this SA.

11. Other Reporting Responsibilities:

(a) If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs.

(b) If other reporting responsibilities are presented in the same section as the related report elements required by the SAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs.

(c) If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements of this SA shall be included under a section with a heading "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements."

12. Signature of the Auditor: The auditor's report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the

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audit firm. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

The report is to be signed by the maker of the report. Normally, a chartered accountant in practice signs the report in the name he is registered as a practitioner. If he is an individual, it may be his individual name or the firm name of which he is the sole proprietor. For those members in practice as a partnership firm, it is usual for them to sign in the firm name. Under Section 145 read with Section 141(2) of the Companies Act, 2013, only the person appointed as an auditor of the company or, where a firm is so appointed, only the partner in the firm who is a chartered accountant, may sign the auditor's report or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.

It is obvious that the person appointed makes the report; otherwise, the very essence of the appointment of a particular man or firm will be lost. In a profession, the particular skill and reputation of the practitioner counts considerably and if anybody else is allowed to make the report on behalf of the person appointed, then this confidence in the person will cease to be a factor. This has other implications also from the point of view of professional responsibility; it will create an unusual legal situation. It also has implications from the standpoint of the practitioner. If in respect of appointments held by him, the reports are made by others, gradually the goodwill of the practitioner will end and the clients may shift to the person actually making the report.

If A, B and C were in practice as ABC & Co. Chartered Accountants, any of A or B or C could sign as "ABC & Co." in his own hand. But now in view of the objection raised by the Department of Company Affairs to this practice, the Council of the Institute in the SA 700 "The Auditor's Report on Financial Statements" has recommended to the members who are in practice in partnership, that signature on or authentication of the auditor's report or any other document required to be signed or authenticated by the auditor should be made in the following manner.



3.

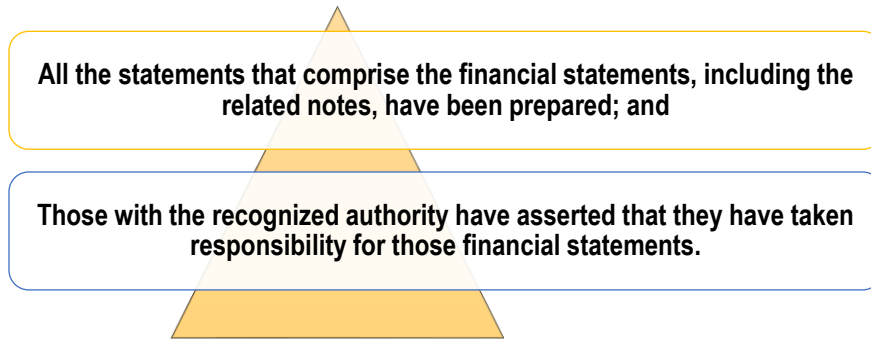
For ABC and Co.
Chartered Accountants
Firm Registration Number
Signature
(Name of the Member Signing the Audit Report)
(Designation {Partner/Proprietor})

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In addition to the provisions of the Companies Act, 2013 referred to above, Clause (12) of Part I of the First Schedule to the Chartered Accountants Act, 1949 provides that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he allows a person, not being a member of the Institute or a member not being his partner, to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements. The provision is intended to safeguard the professional purity by excluding non-chartered accountants from signing the aforesaid documents. By excluding chartered accountants who are not partners, it seeks to keep the line of professional responsibility clear. Partners are mutual agents and therefore, allowing a partner to sign does not interfere with the clarity of responsibility.

13. **Place of Signature:** The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

14. **Date of the Auditor's Report:** The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:



3.3 Auditor's Report Prescribed by Law or Regulation

If the auditor is required by law or regulation applicable to the entity to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements:

(1) A title.

(2) An addressee, as required by the circumstances of the engagement.

(3) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements.

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(4) An identification of the entity's financial statements that have been audited.

(5) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI.

(6) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements of SA 570.

(7) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements of SA 570 (Revised).

(8) Where applicable, a section that includes the information required by SA 701, or additional information about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that SA 701.

(9) A description of management's responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements.

(10) A reference to Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements.

(11) The auditor's signature.

(12) The place of signature

(13) The date of the auditor's report.

Students may note that the Chartered Accountants need to ensure compliance with all the requirements relating to signature prescribed in the relevant law or regulation, SAs and relevant announcements/ clarifications issued by ICAI on the matter including the requirement to mention UDIN (mandatory from 1st July 2019) (UDIN – UNIQUE DOCUMENT IDENTIFICATION NUMBER). The requirement to mention UDIN is applicable both for manually and digitally signed reports/certificates including certificates uploaded online.

For detailed understanding, students may refer the following link:

https://resource.cdn.icai.org/59024aasb48128.pdf

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3.4 Auditor's Report for Audits Conducted in Accordance with Both Standards on Auditing Issued by ICAI and International Standards on Auditing or Auditing Standards of Any Other Jurisdiction

An auditor may be required to conduct an audit in accordance with, in addition to the Standards on Auditing issued by ICAI, the International Standards on Auditing or auditing standards of any other jurisdiction. If this is the case, the auditor's report may refer to Standards on Auditing in addition to the International Standards on Auditing or auditing standards of such other jurisdiction, but the auditor shall do so only if:

(a) There is no conflict between the requirements in the ISAs or such auditing standards of other jurisdiction and those in SAs that would lead the auditor:

(i) to form a different opinion, or

(ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that,

in the particular circumstances, is required by SAs; and

(b) The auditor's report includes, at a minimum, each of the elements set out in Auditor's Report Prescribed by Law or Regulation discussed above when the auditor uses the layout or wording specified by the Standards on Auditing. However, reference to "law or regulation" in above paragraph shall be read as reference to the Standards on Auditing. The auditor's report shall thereby identify such Standards on Auditing.

When the auditor's report refers to both the ISAs or the auditing standards of a specific jurisdiction and the Standards on Auditing issued by ICAI, the auditor's report shall clearly identify the same including the jurisdiction of origin of the other auditing standards.

3.5 Supplementary Information Presented with the Financial Statements

If supplementary information that is not required by the applicable financial reporting framework is:

presented with the audited financial statements, the auditor shall evaluate whether, in the auditor's professional judgment, supplementary information is nevertheless an integral part of the financial statements due to its nature or how it is presented. When it is an integral part of the financial statements, the supplementary information shall be covered by the auditor's opinion.	**not considered an integral part of the audited financial statements, the auditor shall evaluate whether such supplementary information is presented in a way that sufficiently and clearly differentiates it from the audited financial statements. If this is not the case, then the auditor shall ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall identify the unaudited supplementary information and explain in the auditor's report that such supplementary information has not been audited.**

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4. When the notes to the financial statements include an explanation or the reconciliation of the extent to which the financial statements comply with another financial reporting framework, the auditor may consider this to be supplementary information that cannot be clearly differentiated from the financial statements. The auditor's opinion would also cover notes or supplementary schedules that are cross-referenced from the financial statements.

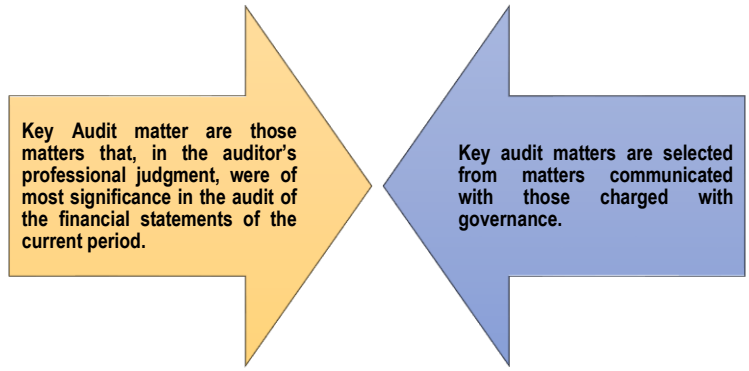
5. When an additional profit and loss account that discloses specific items of expenditure is disclosed as a separate schedule included as an appendix to the financial statements, the auditor may consider this to be supplementary information that can be clearly differentiated from the financial statements.

TEST YOUR UNDERSTANDING 1

The auditors of a listed company have affirmed in their audit report communication of significant audit findings including significant deficiencies in internal control of the company identified to those charged with governance. Where are such matters included in the audit report of a listed company? Also dwell upon the importance of such communication.

4. SA 701 COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT

SA 701 provides guidance regarding communication of Key Audit Matters. This SA deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.



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4.1 Purpose

The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements ("intended users") to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

Objective	• To enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. • To assist the user in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

4.2 Scope

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

(a)	**A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;**
(b)	**A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);**
(c)	**A substitute for reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or**

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(d) A separate opinion on individual matters.

- **a substitute for disclosures in the financial statements;**
- **a substitute for the auditor expressing a modified opinion in case of circumstances of a specific audit engagement as per SA 705;**
- **a substitute for reporting in accordance with SA 570 or**
- **a separate opinion on individual matters.**

Applicability of SA 701	➢ This SA applies to audits of complete sets of general purpose financial statements of: ✎ listed entities and ✎ circumstances when the auditor otherwise decides to communicate key audit matters in the auditor's report and ✎ required by law or regulation to communicate key audit matters in the auditor's report *However, SA 705 (Revised) prohibits the auditor from communicating key audit matters when the auditor disclaims an opinion on the financial statements, unless such reporting is required by law or regulation*

4.3 Determining Key Audit Matters

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

(a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315

(b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

(c) The effect on the audit of significant events or transactions that occurred during the period.

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6-10 Examples of Key Audit Matters:

- Assessment of Impairment,
- Provision for losses and contingencies,
- Valuation of financial instruments,
- Matters relating to Revenue recognition,
- Taxation matters (multiple tax jurisdictions, uncertain tax position, deferred tax assets).

4.4 Communicating Key Audit Matters

The introductory language in this section of the auditor's report shall state that:

(a) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and.

(b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

In case there are no Key Audit Matter to communicate, the auditors' report must specifically mention that by carrying a Key Audit Matter Paragraph and under which they shall mention that there are no Key Audit matters to communicate.

Extract of Independent Auditor's Report – Key Audit Matter

Key audit matter	How our audit addressed the key audit matter
The Bank is required to comply with the Master Circular dated 1 October, 2021 issued by the Reserve Bank of India ("RBI") on "Prudential Norms for Income Recognition, Asset Classification and Provisioning pertaining to Advances" (the "IRAC norms") and amendments thereto which prescribes the guidelines for identification and classification of Non-performing Assets ("NPAs") and the minimum provision required for such assets. The Bank is also required to apply its judgement to determine the identification and provision required against NPAs considering various quantitative as well as qualitative factors. The identification of NPAs is also affected by factors like stress and liquidity concerns in certain sectors. The provision for identified NPAs is estimated based on ageing and classification of NPAs, value of security, recovery estimates etc. and is also subject to the minimum provisioning norms specified by RBI. In addition, the Bank is also required to implement "Resolution Framework – 2.0: Resolution of COVID-19 related stress of Individuals and Small Businesses" and "Resolution Framework – 2.0: Resolution of COVID-19 related stress of Micro, Small and Medium Enterprises (MSMEs)" issued by the RBI on 5 May 2021 (collectively "Resolution Framework – 2.0"), and consider the same in identification of NPAs and measurement of provision against advances. Since the identification of NPAs and provisioning for advances requires considerable level of management estimation, application of various regulatory requirements and its significance to the overall audit, we have identified this as a key audit matter.	Our audit procedures included the following: • Understood the process and controls, and tested the design and operating effectiveness of key controls, including Information Technology based controls, and focused on the following: - Approval of new lending facilities in accordance with the Bank's credit policies - Performance of annual review/renewal of loan accounts. - Monitoring of credit quality which amongst other things includes the monitoring of overdue loan accounts, drawing power limit, pending security creation; - Identification and classification of NPAs in accordance with IRAC norms, other regulatory guidelines issued by the RBI and consideration of qualitative aspects; and - Assessment of adequacy of NPA provisions. • Tested the Bank's process for identification of loans with default events and/ or breach of other qualitative factors, and for a sample of performing loans, independently assessed as to whether there was a need to classify such loans as NPAs. • On a test check basis, verified the accounts classified by the Bank as Special Mention Accounts ('SMA') in RBI's Central Repository of Information on Large Credits ('CRILC'). • Inquired with the management of the Bank on sectors where there has been stress and the steps taken by the Bank to mitigate such sectorial risks.

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The key audit matter	How the matter was addressed in our audit
As disclosed in note 25 to the standalone financial statements, revenue is measured net of any trade discounts and volume rebates to customers ("discounts and rebates"). Certain discounts and rebates for goods sold during the year are only finalised when the precise amounts are known, and revenue therefore includes an estimate of variable consideration. The variable consideration represents the portion of discounts and rebates that are not directly deducted on the invoice and involves estimation by the Company in recognition and measurement of such discounts and rebates. This includes establishing an accrual at year end, particularly in arrangements with customers involving varying terms which are based on annual contracts or shorter-term arrangements. In addition, the value and timing of promotions for products varies from period to period, and the activity can span beyond the year end. The unsettled portion of the variable consideration results in discounts and rebates due to customers as at year end. Therefore, there is a risk of revenue being overstated due to fraud through manipulation of discounts and rebates accruals recognised, resulting from pressure the Company may feel to achieve performance targets at the year end. We identified the evaluation of accrual for discounts and rebates as a key audit matter.	**Our audit procedures included:** • Understanding the process followed by the Company to determine the amount of accrual for discounts and rebates. • Evaluating the design and implementation and testing operating effectiveness of Company's general IT controls, key manual and application controls over the Company's IT systems including controls over rebates agreements / arrangements, rebate payments / settlements and Company's review over the rebate accruals. • Inspecting on a sample basis, key customer contracts. Based on the terms and conditions relating to discounts and rebates, assessing the Company's revenue recognition policies with reference to the requirements of the applicable accounting standards. • Performing substantive testing by selecting samples of discounts and rebates transactions recorded during the year as well as period end discounts and rebates accruals and matching the parameters used in the computation with the relevant source documents.

ILLUSTRATION 2

The following illustrates the presentation in the auditor's report if the auditor has determined there are no key audit matters to communicate:

Key Audit Matters

[Except for the matter described in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section,] We have determined that there are no [other] key audit matters to communicate in our report.]

5. SA 705 MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

Modified Opinions: SA 705 deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

5.1 Types of Modified Opinions

Types of Modified Opinions as per SA 705	(i) Qualified Opinion
	(ii) Adverse Opinion
	(iii) Disclaimer of Opinion

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The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

5.2 Objective

The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

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

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

5.3 Circumstances When a Modification to the Auditor's Opinion is Required

The auditor shall modify the opinion in the auditor's report when:

The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; **or**	The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

5.4 Determining the Type of Modification to the Auditor's Opinion

5.4.1 Qualified Opinion: The auditor shall express a qualified opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

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Illustrative Audit Opinion

ILLUSTRATION 3

XYZ Ltd. is a company engaged in the manufacture of cranes. CA Sudhir is the statutory auditor of the company for the FY 2023-24. The company has taken long-term funding for fixed capital requirements and short-term funding for its working capital requirements. During the course of audit, CA Sudhir found that the company's financing arrangements are about to expire, and the company is unable to re- negotiate or obtain the replacement financing. As such the company may be unable to realize its assets and discharge its liabilities in the normal course of business. Notes to accounts annexed to the financial statements discuss the magnitude of financing arrangements, the expiration and the total financing arrangements; however, the financial statements do not include discussion on the impact or the availability of refinancing. Thus, the financial statements (and notes thereto) do not fully disclose this fact. What kind of opinion should CA Sudhir issue in case of XYZ Ltd.?

SOLUTION

In the present case, XYZ Ltd. is unable to re- negotiate or obtain the replacement financing for its long term and short-term funding requirements. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore, XYZ Ltd. may be unable to realize its assets and discharge its liabilities in the normal course of business. Further, the financial statements of XYZ Ltd. do not disclose this fact adequately.

Thus, the financial statements of XYZ Ltd. are materially misstated due to the inadequate disclosure of the material uncertainty. CA Sudhir will express a qualified opinion as the effects on the financial statements of this inadequate disclosure are material but not pervasive to the financial statements.

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion section of our report, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of XYZ Ltd. as at March 31, 2024, and profit/loss, for the year ended on that date.

Basis for Qualified Opinion

As discussed in Note 6, the Company's financing arrangements are about to expire, and the Company has been unable to conclude renegotiations or obtain replacement financing. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this matter.

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5.4.2 Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

ILLUSTRATION 4

ABC Ltd. is a company engaged in the manufacture of iron and steel bars. PP & Associates are the statutory auditors of ABC Ltd. for FY 2023-24. During the course of audit, CA Prakash, the engagement partner, found that the Company's financing arrangements have expired, and the amount outstanding was payable on March 31, 2024. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact. What opinion should CA Prakash express in the case of ABC Ltd.?

SOLUTION

In the present case based on the audit evidence obtained, CA Prakash has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and the entity is considering bankruptcy. The financial statements of ABC Ltd. omit the required disclosures relating to the material uncertainty.

In such circumstances, CA Prakash should express an adverse opinion because the effects on the financial statements of such omission are material and pervasive.

The relevant extract of the Adverse Opinion Paragraph and Basis for Adverse Opinion paragraph is as under:

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly, the financial position of the entity as at March 31, 2024, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

The financing arrangements of ABC Ltd. have expired, and the amount outstanding was payable on March 31, 2024. The entity has been unable to conclude re-negotiations or obtain replacement financing and is considering filing for bankruptcy. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this fact.

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5.4.3 Disclaimer of Opinion: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.



11. Draft Disclaimer of Opinion

We were engaged to audit the financial statements of ABC & Associates ("the entity"), which comprise the balance sheet as at March 31, 20XX, the statement of Profit and Loss, [the statement of changes in equity (where applicable)] and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the entity. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

ILLUSTRATION 5

MNO Ltd. is a power generating company having its plants in the northeastern states of the country. For the FY 2023-24, M/s PRT & Associates are the statutory auditors of the company. During the audit, the audit team was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment (in XYZ Ltd.) that represents over 90% of the entity's net assets. What kind of opinion should the statutory auditor's issue in such case?

SOLUTION

M/s PRT & Associates are unable to obtain sufficient appropriate audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are both material and pervasive to the consolidated financial statements.

Therefore, the statutory auditor should issue a disclaimer of opinion.

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The relevant extract of the Disclaimer of Opinion Paragraph and Basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We do not express an opinion on the accompanying financial statements of MNO Ltd. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture XYZ Company is carried at ₹ 95 crores on the Group's consolidated balance sheet, which represents over 90% of the Group's net assets as at March 31, 2024. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, (and the elements making up the consolidated statement of changes in equity) and the consolidated cash flow statement.

What is Pervasive: Pervasive is a term used in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that in the auditor's judgment:
— Are not confined to specific elements, accounts or items of the financial statements;
— If so confined, represent or could represent a substantial proportion of the financial statements; or
— In relation to disclosures, are fundamental to users' understanding of the financial statements.

Pervasive, therefore, is that which is not localised to any one or two elements of a financial statements, but the impact is across various elements of the financial statements.

For example, if sufficient appropriate audit evidence is not available for say Inventory but the other elements are properly supported by documentary evidence then the non-availability of information on Inventory is localized to possible misstatement of inventory but has no impact on the other elements like trade receivables, PPE, loans, trade payables etc.

Therefore, it is necessary to ascertain whether the impact of misstatement is pervasive or not pervasive.

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5.5 Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:	
(a)	If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
(b)	If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
	(i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or
	(ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

5.6 If the Auditor Decides to Withdraw

When the auditor decides to withdraw before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

5.6.1 Where Auditors' withdrawal is not permitted: The listing agreement and the Securities and Exchange Board of India's directive on the resignation of auditor does not permit withdrawing from the engagement without issuing the audit / review report. The said directive contained in circular no. CIR/CFD/CMD1/114/2019 dated October 18, 2019, issued by the Securities and Exchange Board of India inter-alia provides that

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If the auditor proposes to resign:

a) within 45 days from the end of any of the quarters of a period covered under the appointment, then the auditor shall, before such resignation, issue the audit / limited review report for such quarter.

b) after 45 days from the end any of the quarters of a period covered under the appointment, then we shall, before such resignation, issue the audit / Limited review report for such quarter as well as the next quarter.

c) If the Limited review report has been issued for all the three quarters, then the auditor shall issue the audit report for the full year before resigning from the engagement.

ICAI announcement on the Resignation of Auditor: The ICAI has made an announcement that the auditor of an unlisted company shall not mention "professional pre-occupation" as a reason for the resignation. The auditor shall mention the reasons clearly for the resignation in the resignation letter issued to the Company.

5.7 Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion

When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement. To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole.

5.8 Form and Content of the Auditor's Report When the Opinion is Modified

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section.

What special consideration are required for expressing Qualified Opinion?

When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section:

(a) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) […] in accordance with [the applicable financial reporting framework]; or

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(b) When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

ILLUSTRATION 6

CA Yash is the statutory auditor of Laksmi Vardhan Limited for the FY 2023-24. In respect of loans and advances of ₹55,00,000/- given to Sarvagya Private Limited, the Company has not furnished any agreement to CA Yash and in absence of the same, he is unable to verify the terms of repayment, chargeability of interest and other terms.

What kind of opinion should CA Yash give in such situation?

SOLUTION

In the present case, with respect to loans and advances of ₹ 55,00,000/- given to Sarvagya Private Limited, the Company has not furnished any agreement to CA Yash. In absence of such agreement, CA Yash is unable to verify the terms of repayment, chargeability of interest and other terms. For an auditor, while verifying any loans and advances, one of the most important audit evidences is the loan agreement. Therefore, the absence of such a document in the present case, tantamount to a material misstatement in the financial statements of the company. However, the inability of CA Yash to obtain such audit evidence is though material but not pervasive so as to require him to give a disclaimer of opinion.

Thus, in the present case, CA Yash should give a qualified opinion

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the financial statements of Laksmi Vardhan Limited give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of th Company as on 31.03.2024 and profit/ loss for the year ended on that date.

Basis for Qualified Opinion

The Company is unable to furnish the loan agreement with respect to loans and advances of ₹ 55,00,000/- given to Sarvagya Private Limited. Consequently, in the absence of such an

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agreement, we are unable to verify the terms of repayment, chargeability of interest and other terms.

What special consideration is needed for expressing Adverse Opinion?

When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section:

(a) When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) […] in accordance with [the applicable financial reporting framework]; or

(b) When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

ILLUSTRATION 7

In the financial year 2023-24, MSD Ltd. faced an extraordinary event (earthquake), which destroyed a lot of business activity of the company. These circumstances indicate material uncertainty about the company's ability to continue as going concern. Due to such an event, it may not be possible for the company to realize its assets or pay off the liabilities during the regular course of its business. The financial statement and notes to the financial statements of the company do not disclose this fact. What kind of opinion should the statutory auditor of MSD Ltd. issue in such circumstances?

SOLUTION

In the present case, there exists a material uncertainty that casts a significant doubt on the company's ability to continue as going concern and the same is not disclosed in the financial statements of MSD Ltd.

As such, the financial statements of MSD Ltd. for the FY 2023-24 are materially misstated, and the effect of the misstatement is so material and pervasive on the financial statements that giving only a qualified opinion will be insufficient and therefore the statutory auditor of MSD Ltd. should issue an adverse opinion.

The relevant extract of the Adverse Opinion Paragraph and Basis for Adverse Opinion paragraph is as under:

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly, the financial position of MSD Ltd. as on March 31, 2024, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

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Basis for Adverse Opinion

MSD Ltd. has faced an extraordinary event (earthquake), which destroyed a lot of business activity of the company. Due to such an event, it may not be possible for the company to realize its assets or pay off the liabilities during the regular course of its business. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statement and notes to the financial statements of the company do not disclose this fact.

What special consideration is required for expressing Disclaimer of Opinion?

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

(a) State that the auditor does not express an opinion on the accompanying financial statements;

(b) State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(c) Amend the statement required in SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

ILLUSTRATION 8

CA Abhimanyu is the statutory auditor of PQR Ltd. for the FY 2023-24. During the course of audit CA Abhimanyu noticed the following:

1. ***With respect to the debtors amounting to ₹ 150 crores, no balance confirmation was received by the audit team. Further, there have been defaults on the payment obligations by debtors on the due dates during the year under audit. The Company has created a provision for doubtful debts to the tune of ₹ 25 crores. during the year under audit. The Company has stated that the provision is based on receivables which are older than 36 months, which according to the audit team is inadequate and as such the audit team is unable to ascertain the carrying value of trade receivables.***

2. ***Further, in respect of Inventories (which constitutes 40% of the total assets of the company), during the reporting period, the management has not undertaken physical verification of inventories at periodic intervals. Also, the Company has not maintained adequate inventory records at the factory. The audit team was unable to undertake the physical inventory count as such the value of inventory could not be verified.***

Under the above circumstances what kind of opinion should CA Abhimanyu give?

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SOLUTION

In the present case, CA Abhimanyu is unable to obtain sufficient and appropriate audit evidence with respect to the following:

1. The balance confirmation with respect to debtors amounting to ₹ 150 crores is not available. Further there has been default in payment by the debtors and the provision so made is not adequate. The audit team is also unable ascertain the carrying value of trade receivables.
2. With respect to 40% of the company's inventory, neither the physical verification has been done by the management nor are adequate inventory records maintained. The audit team is also unable to undertake the physical inventory count as such the value of inventory could not be verified.

In the above two circumstances the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Thus, CA Abhimanyu should give a Disclaimer of Opinion.

The relevant extract of the Disclaimer of Opinion Paragraph and Basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We do not express an opinion on the accompanying financial statements of PQR Ltd. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We are unable to obtain balance confirmation with respect to the debtors amounting to ₹ 150 crores. Further, there have been defaults on the payment obligations by debtors on the due dates during the year under audit. The Company has created a provision for doubtful debts to the tune of ₹ 25 crores during the year under audit which is inadequate in the circumstances of the company. The carrying value of trade receivables could not be ascertained.

Further, in respect of Inventories (which constitutes 40% of the total assets of the company), during the reporting period, the management has not undertaken physical verification of inventories at periodic intervals. Also, the Company has not maintained adequate inventory

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records at the factory. We were unable to undertake the physical inventory count and as such the value of inventory could not be verified.

Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.

What is the Basis for Modification of Opinion (Qualified/Disclaimer /Adverse)?

When the auditor modifies (Qualification/ Disclaimer/ Adverse) the opinion as above on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

(a) Amend the heading "Basis for Opinion" to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and

(b) Within this section, include a description of the matter giving rise to the modification.

If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures in the notes to the financial statements), the auditor shall include in the Basis for Opinion section, a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in this section.

If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.

If there is a material misstatement of the financial statements that relates to the non- disclosure of information required to be disclosed, the auditor shall:

(a) Discuss the non-disclosure with those charged with governance;

(b) Describe in the Basis for Opinion section the nature of the omitted information; and

(c) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.

When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion to include the word "qualified" or "adverse", as appropriate.

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When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include following elements required under SA 700

(a) A reference to the section of the auditor's report where the auditor's responsibilities are described; and

(b) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.

How should Auditor give description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements?

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

(a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;

(b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(c) The statement about auditor independence and other ethical responsibilities required in SA 700.

Matrix to be considered to determine what type of modified opinion should be used by the Auditor: When the auditor concludes that there exists a material misstatement which precludes the auditor from issuing an un-modified opinion, the auditor must determine which type of modified opinion is to be issued by the auditor as per SA 705 – Modifications to the Opinion in the Independent Auditors Report. The following matrix assists the auditor in determining the type of modified opinion.

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Nature of Matter Giving Rise to the Modification	Auditor's judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but not pervasive	Material and pervasive
Financial Statements are materially misstated	Qualified Opinion	Adverse Opinion
Inability to obtain Sufficient appropriate audit evidence	Qualified Opinion	Disclaimer of Opinion

5.9 Communication with Those Charged with Governance

When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification. The Auditor is required to discuss and deliberate with those charged with governance the audit findings and the type of misstatements.

6 SA 706 EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

6.1 Objective

The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

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6.2 When to give Emphasis of Matter Paragraphs in the Auditor's Report?

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

(a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and

(b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.



12. These circumstances may include:

- When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
- To alert users that the financial statements are prepared in accordance with a special purpose framework.
- When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).

6.3 Inclusion of an Emphasis of Matter Paragraph in the Auditor's Report

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

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When to issue Other Matter Paragraphs in the Auditor's Report?

If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:

(a) This is not prohibited by law or regulation; and

(b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.



13. Circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- **An uncertainty relating to the future outcome of exceptional litigation or regulatory action.**
- **A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.**
- **Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.**
- **A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.**

ILLUSTRATION 9

In respect of the audit of BDS Ltd., the statutory auditor of the company noticed some matters. The statutory auditor wants to draw the user's attention towards such matters, though his opinion is not modified in respect of such matters. Draft the relevant paragraphs of the audit report for the following matters:

i. The company has a plan to resume its construction activities with respect to one of its thermal power project, The activity of such power plant was suspended in the

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FY 2021-22. The thermal power project comprises of the plant and equipment amounting to ₹ 5.95 crore and capital work in progress of ₹ 147.50 crore.

ii. The financial statements of 5 branches are included in the Standalone Financial Statements of BDS Ltd. whose financial statements reflect total assets of ₹ 90 crores as at 31.03.2024 and total revenue from operations of ₹ 40 crores for the year ended on that date. The financial statements of these branches have been audited by the branch auditors.

SOLUTION

Emphasis of Matter

We draw attention to the following note of the standalone financial statements:

Note 27 regarding the plans of the Company to resume construction/developmental activities of a thermal power project. The carrying amounts related to the project as at 31st March, 2024 comprise of plant and equipment of ₹ 5.95 crore and capital work in progress of ₹ 147.50 crore.

Our opinion is not modified in respect of this matter.

Other Matter

We did not audited the financial statements of 5 branches included in the Standalone Financial Statements of the company whose financial statements reflect total assets of ₹ 90 crores as at 31.03.2024 and total revenue from operations of ₹ 40 crores for the year ended on that date. The financial statements of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of these branches, is based solely on the report of the branch auditors.

Our opinion is not modified in respect of this matter.

Is there any duty to communicate with Those Charged with Governance?

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.

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Extract of Independent Auditor's Report – Emphasis of Matter Para & Other Matter

Emphasis of Matter Paragraph

We draw attention to Note no. 7 of the Statement wherein during the quarter ended September 30, 2022, the Board of Directors of [redacted] decided to provide for interest on borrowings which were previously not recognised in the books of account for the reasons stated in the said note. Accordingly, the figures for the previous periods / years of other current financial liability, finance cost, profit / (loss) before tax, Earnings per share and Other equity has been impacted on such restatement. Consequently the figures of the consolidated financial results of the Holding Company also stand restated. The effect of the restatement in the consolidated financial results has been disclosed in Note 7 of the Statement. Our conclusion on the Statement is not modified in respect of this matter.

Other Matters

1. The consolidated financial results include the audited financial results of 32 subsidiaries, whose financial statements / financial information reflect total assets of Rs. 8,30,863 lakhs as at March 31, 2023, total revenue of Rs. 5,698 lakhs and Rs. 24,372 lakhs, net loss after tax of Rs. 20,604 lakhs and Rs. 52,472 lakhs and total comprehensive loss of Rs. 20,641 lakhs and Rs. 52,514 lakhs for the quarter and year ended March 31, 2023 respectively and cash outflows of Rs. 4,678 lakhs for the year ended March 31, 2023, as considered in the consolidated financial results, which have been audited by their respective independent auditors. The consolidated financial results also includes the Group's share of net loss after tax of Rs. Nil and Rs. Nil and total comprehensive income of Rs. Nil and Rs. Nil for the quarter and year ended March 31, 2022 respectively as considered in the consolidated financial results in respect of 3 associates, which have been audited by their respective independent auditors. The independent auditors' reports on financial statements / financial information of these entities have been furnished to us and our opinion on the consolidated financial results, in so far as it relates to the amounts and disclosures included in respect of these entities, is based solely on the report of such auditors and the procedures performed by us are as stated in paragraph above.

   Our opinion on the consolidated financial results is not modified in respect of the above matters with respect to our reliance on the work done and the reports of the other auditors.

2. The consolidated financial results include the results for the quarter ended March 31, 2023 and March 31, 2022 being the balancing figures between the audited figures in respect of the full financial year and the published unaudited year to date figures up to the third quarter of the respective financial year which were subject to limited review by us.

Note: Students are advised to refer Illustration of Emphasis of Matter Para as given in appendix at the end of the Chapter.

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Relationship between Emphasis of Matter Paragraphs and Key Audit Matters in the Auditor's Report	
Key audit matters— Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. [SA 701]	**Emphasis of Matter paragraph –** A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements. [SA 706]
Matters that are determined to be key audit matters in accordance with SA 701 may also be, in the auditor's judgment, fundamental to users' understanding of the financial statements. In such cases, in communicating the matter as a key audit matter in accordance with SA 701, the auditor may wish to highlight or draw further attention to its relative importance. Communicating Key Audit Matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit and may also assist them in understanding the entity and areas of significant management judgment in the audited financial statements.	A widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters. Use of Emphasis of Matter paragraphs is not a substitute for a description of individual key audit matters where SA 701 is applicable. There may be a matter that is not determined to be a key audit matter in accordance with SA 701 (i.e., because it did not require significant auditor attention), but which, in the auditor's judgment, is fundamental to users' understanding of the financial statements (e.g., a subsequent event). If the auditor considers it necessary to draw users' attention to such a matter, the matter is included in an Emphasis of Matter paragraph in the auditor's report in accordance with this SA.
The communication of key audit matters in the auditor's report may also provide intended users a basis to further engage with management and those charged with governance about certain matters relating to the entity, the audited financial statements, or the audit that was performed.	The auditor may do so by presenting the matter more prominently than other matters in the Key Audit Matters section (e.g., as the first matter) or by including additional information in the description of the key audit matter to indicate the importance of the matter to users' understanding of the financial statements.

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SA-706
Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

Scope
- This SA deals with additional communication in the auditor's report when the auditor considers it necessary to draw users' attention to a matter or matters
- (a) presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or
- (b) other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Objectives
- The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

(a)A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

(b)As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Definitions
- **Emphasis of Matter paragraph :** A paragraph included in the auditor's report that refers to ***a matter appropriately presented or disclosed*** in the financial statements that, in the ***auditor's judgment***, is of such importance that it is ***fundamental to users*** understanding of the financial statements.
- **Other Matter paragraph:** A paragraph included in the auditor's report that refers to a matter ***other than those presented or disclosed*** in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Requirements
- **Emphasis of Matter Paragraphs in the Auditor's Report**
  - **When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall**:
  - (a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
  - (b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
  - (c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.
- **Other Matter Paragraphs in the Auditor's Report**
  - If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:
    - (a)This is not prohibited by law or regulation; and
    - (b)When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.
  - The auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.
- **Communication with Those Charged with Governance**
  - If the auditor expects to include an ***Emphasis of Matter or an Other Matter paragraph*** in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.

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7. DISTINCTION BETWEEN NOTES ON ACCOUNTS AND QUALIFICATIONS

As a general practice, the management would normally prefer to explain their view point and assessment on all matters involving difference of opinion between them and the auditors by way of notes in the financial statements, for better understanding of the facts of the matters by users of financial statements. Such notes represent management's stand on the matter while the auditor records his disagreement on the matters by way of qualifications in the auditor's report.

Students should note that client and auditor are two separate independent parties and in real life situations, at times, the client management may insist upon the auditor for not modifying his audit opinion considering the management has disclosed full facts and assessment of the matter through notes on the financial statements. However, the auditor needs to exercise his professional judgement and assess if the disclosure alone would suffice or in case, he also needs to modify his audit report by either inserting a qualification or Emphasis of matter. {it is clarified that emphasis of matter is not a substitute for modification of opinion}.

The Emphasis of Matter is to be made in respect of something which is appropriately presented and for which the auditor has obtained sufficient appropriate audit evidence.

Once auditor concludes that modification of his report in relation to the specific matter under question, is warranted, he may choose to refer to the specific note given by the management and thereafter, continue explaining more facts and his assessment on the matter including quantification and impact on the various financial statement's captions, to the extent possible.

The Auditor must express the nature of qualification, in a clear and unambiguous manner. Where the Auditor answers any of the statutory affirmations in the negative or with a qualification, his report shall state the reasons for such an answer. All qualifications should be contained in the Auditor's Report.

Where the company has committed an irregularity resulting in a breach of law, the Auditor should bring the same to the notice of the shareholders by properly qualifying his report. A quantified opinion should be expressed as "except for" for the effects of the matter to which the qualification related. It would not be appropriate to use phrases such as "with the foregoing explanation" or "subject to" in the opinion paragraph as these are not sufficiently clear or forceful.

Notes – Report Relationship – Where notes of a qualificatory nature appear in the accounts, the Auditors should state all qualifications independently in their report so that the user can assess the significance of these qualifications. A reference to the notes to Accounts in the Auditors' Report does

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not automatically become a qualification. The report must categorically state the matter from the auditor's standpoint and not from the management stand point.

Note : Students are advised to refer examples/illustrative formats given at the end of the Chapter for better understanding of the differences.

TEST YOUR UNDERSTANDING 2

Below is draft extract of audit report of a listed company. Para (A) below reflects certain matters stated in audit report communicated with CFO of company and Para (B) is in nature of auditor's response to said matter.

(A) The Company recognizes revenues when the control of goods is transferred to the customer at the net consideration which the Company expects to receive for those goods from customers in accordance with contracts terms and conditions.

The terms of sales arrangements based on the terms and conditions of relevant contracts and nature of discount and rebates create complexities that require judgment in determining revenues.

(B) We read the Company's revenue recognition policy and assessed its compliance in terms of Ind AS 115 "Revenue from contracts with customers".

We assessed design and tested the operating effectiveness of internal controls related to sales and rebates/discounts.

We tested on a sample basis that revenue has been recognized in the proper period with reference to the supporting documents including confirmations from customers.

From the description given above, identify what auditors are trying to report and under what heading such matter should be reflected in audit report of the company?

TEST YOUR UNDERSTANDING 3

PTD Limited is engaged in the business of executing construction contracts for its clients. There are non-current receivables outstanding in the financial statements of the company as on 31st March, 2024 for ₹ 500 crore. Such amounts represent caused by claims raised by the company on its clients relating to cost overruns necessitated due to delays clients, change in work specifications and related matters. Bes des negotiations, the company has also gone for arbitration in some of the said cases. The management of the company has considered the above amounts to be fully recoverable as stated in notes to accounts.

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CA Piyush, auditor of the company, has relied only upon management representation in this regard. Besides, he has decided to include the said matter in "Emphasis of Matter" Paragraph in audit report.

How do you view decision to include above matter in "Emphasis of Matter" Paragraph by auditor of the company?

8. DISTINCTION BETWEEN AUDIT REPORT AND CERTIFICATE

The term 'report' is used where an expression of opinion is involved. The term 'certificate' is preferable where the auditor comments on or verifies facts such as a verification of investment by inspection or the checking of ballot papers on a poll in a company meeting. Under the Companies Act, 2013, a number of situations are there where an auditor is required to issue a certificate rather than a report, like under Section 66 of the Companies Act, 2013, an auditor is required to file a certificate in the tribunal where company is proposing for the reduction of capital. However, the report under Section 143 of the Companies Act, 2013, is an opinion-based report and is not a certificate.

9. COMMUNICATION TO MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE

As per SA 260 Communication with Those Charged with Governance, it is auditor's responsibility to communicate with those charged with governance in an audit of financial statements irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities.

The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate. If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body.

9.1 When All of Those Charged with Governance are Involved in Managing the Entity

In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those persons(s) also have governance responsibilities, the

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matters need not be communicated again with those same persons(s) in their governance role. These matters are noted in paragraph 16(c). The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.

9.2 Matters to be Communicated

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

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

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

9.3 Planned Scope and Timing of the Audit

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

9.4 Significant Findings from the Audit

The auditor shall communicate with those charged with governance:

(a)	The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;
(b)	Significant difficulties, if any, encountered during the audit;
(c)	Unless all of those charged with governance are involved in managing the entity: i. Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and ii. Written representations the auditor is requesting;
(d)	Circumstances that affect the form and content of the auditor's report, if any; and
(e)	Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

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10. REPORTING REQUIREMENTS IN CASE OF COMPARATIVE INFORMATION

SA 710 Comparative Information-Corresponding Figures and Comparative Financial Statements deals with auditor's responsibility regarding comparative information in an audit of financial statement. There are two different broad approaches to the auditor's responsibilities in respect of comparative information: Corresponding figures and Comparative financial statement.

The essential audit reporting differences between the approaches are:

(a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas

(b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

> The objectives of the auditor are to obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and to report in accordance with the auditor's reporting responsibilities.

10.1 Audit Procedures for Comparative Information:

(a) **Perform Specific audit Procedure:** For determining that the financial statement contains appropriately classified comparative information, the auditor should:

- Ensure that comparative information agrees with the amount and other disclosure presented in the prior period.
- The accounting policies applied are consistent with those applied in current period.
- If there have been any changes in the application of accounting policies than they are properly disclosed and presented.

(b) **Evaluating the impact on financial statement:** If the auditor becomes aware of any possible misstatement in the comparative information, then:

- He should perform the necessary audit procedures to obtain sufficient audit evidence.
- If the auditor had audited the prior period's financial statement than he should follow the relevant requirements of SA 560.

(c) **Written Representation:** As required by SA 580, the auditor should also request written representation. He should also obtain a specific written representation regarding any prior period item that is disclosed in current year's financial statement.

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10.2 Audit Reporting

(a) **With Reference to Corresponding Figures:** When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

- If the auditor's report of the previous period contains other than an unqualified opinion.
- If the auditor is of the opinion, and he has sufficient evidence in this regard, that a material misstatement exists in the financial statement of prior period, which was not addressed earlier.

If the prior period financial statement are not audited, than he should obtain sufficient audit evidence that the opening balance does not contain any material misstatement.

(b) **With Reference to Comparative Financial Statement:** When comparative financial statement are presented -

- The auditor's opinion shall refer to each period for which the financial statements are presented.
- When reporting on current period's audit, if the auditor's opinion on such prior period financial statement differs from the opinion previously issued on such financial statement, the auditor shall disclose the substantive reason for the different opinion in other matter paragraph in his report.
- If the auditor concludes that a material misstatement is present in the previously audited figures of financial statement, he should report it to the appropriate level of the management and request that the predecessor auditor be informed. If then the prior years statements are amended with new report by the predecessor auditor, then the auditor shall report only on the current period.

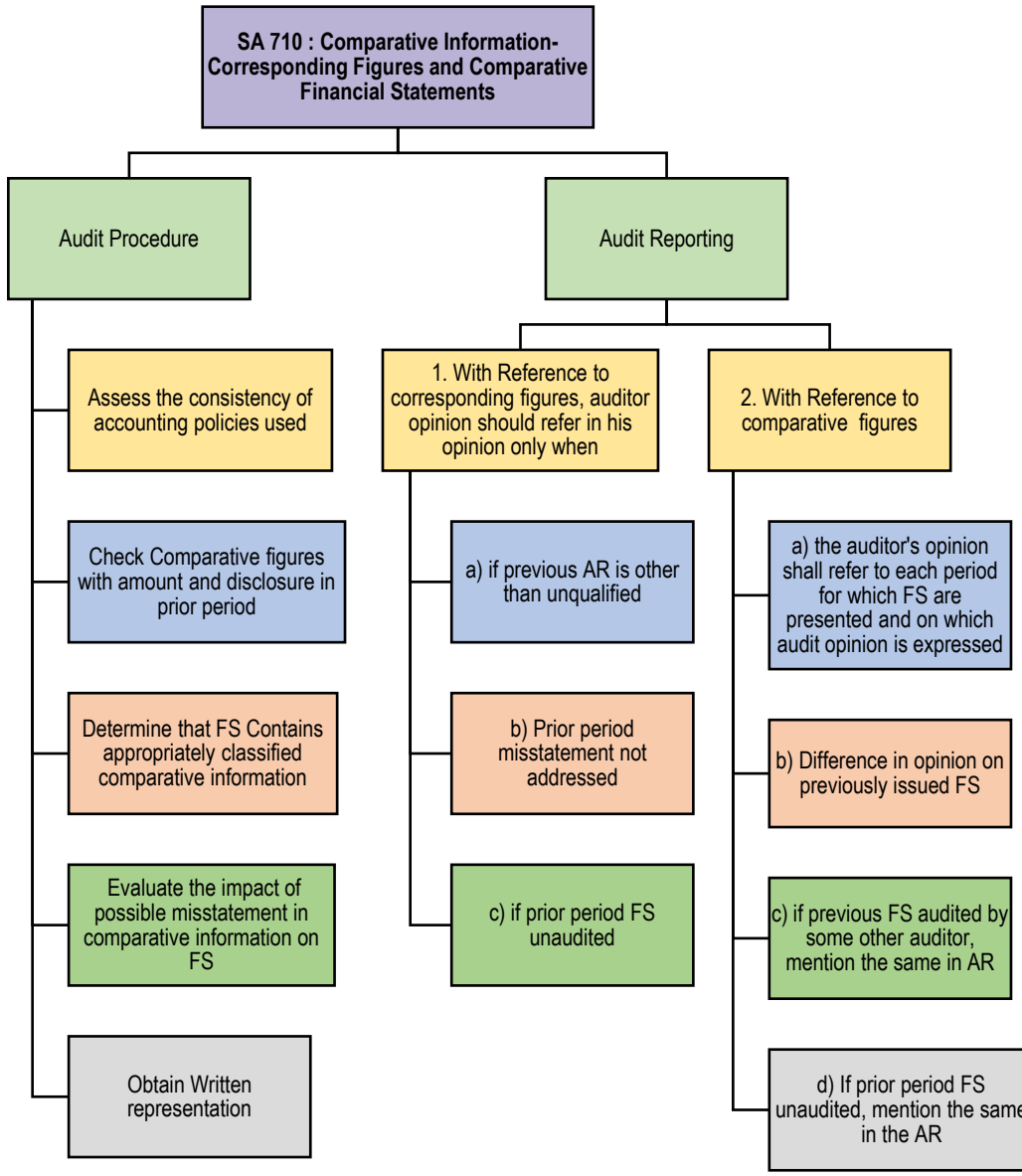
(c) **Reporting treatment common to both (for corresponding figures and comparative information):**

(i) If the financial statement of the prior period were audited by a predecessor auditor, the auditor (is permitted by law or regulation to refer to the predecessor audit report – on case of corresponding figures and decides to do so) shall state in his audit report:

- That the financial statement of the prior period were audited by a predecessor auditor;
- The type of the opinion expressed by the predecessor auditor;
- The date of that audit report.

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(ii) If the prior period financial statement were not audited than he shall report the same in other matter paragraph in his audit report that the corresponding/comparative figures are unaudited. However, the disclosure does not relieve him from his responsibility of obtaining sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.



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11. SA 720 THE AUDITOR'S RESPONSIBILITIES RELATING TO OTHER INFORMATION

This Standard on Auditing (SA) deals with the auditor's responsibilities relating to other information, whether financial or non-financial information (other than financial statements and the auditor's report thereon), included in an entity's annual report. An entity's annual report may be a single document or a combination of documents that serve the same purpose.

This SA requires the auditor to read and consider the other information because other information that is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit may indicate that there is a material misstatement of the financial statements or that a material misstatement of the other information exists, either of which may undermine the credibility of the financial statements and the auditor's report thereon. Such material misstatements may also inappropriately influence the economic decisions of the users for whom the auditor's report is prepared.

This SA does not apply to preliminary announcements of financial information; or securities offering documents, including prospectuses.

Important Definition:

(a) *Annual report* – A document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom, the purpose of which is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements. An annual report contains or accompanies the financial statements and the auditor's report thereon and usually includes information about the entity's developments, its future outlook and risks and uncertainties, a statement by the entity's governing body, and reports covering governance matters.

(c) *Other information* – Financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report.

11.1 Objective

The objectives of the auditor, having read the other information, are:

(a) To consider whether there is a material inconsistency between the other information and the financial statements;

(b) To consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit;

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(c) To respond appropriately when the auditor identifies that such material inconsistencies appear to exist, or when the auditor otherwise becomes aware that other information appears to be materially misstated; and

(d) To report in accordance with this SA.

Other information may include amounts or other items that are intended to be the same as, to summarize, or to provide greater detail, about amounts or other items in the financial statements, and other amounts or other items about which the auditor has obtained knowledge in the audit. Other information may also include other matters.

11.2 Obtaining the Other Information

The auditor shall:

(a) Determine, through discussion with management, which document(s) comprises the annual report, and the entity's planned manner and timing of the issuance of such document(s);

(b) Make appropriate arrangements with management to obtain in a timely manner and, if possible, prior to the date of the auditor's report, the final version of the document(s) comprising the annual report; and

(c) When some or all of the document(s) determined in (a) will not be available until after the date of the auditor's report, request management to provide a written representation that the final version of the document(s) will be provided to the auditor when available, and prior to its issuance by the entity, such that the auditor can complete the procedures required by this SA.

Reading and Considering the Other Information

The auditor shall read the other information and, in doing so shall:

(a) Consider whether there is a material inconsistency between the other information and the financial statements. As the basis for this consideration, the auditor shall, to evaluate their consistency, compare selected amounts or other items in the other information (that are intended to be the same as, to summarize, or to provide greater detail about, the amounts or other items in the financial statements) with such amounts or other items in the financial statements; and

(b) Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit.

While reading the other information in accordance with above, the auditor shall remain alert for indications that the other information not related to the financial statements or the auditor's knowledge obtained in the audit appears to be materially misstated.

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11.3 Responding When a Material Inconsistency Appears to Exist or Other Information Appears to be Materially Misstated

If the auditor identifies that a material inconsistency appears to exist (or becomes aware that the other information appears to be materially misstated), the auditor shall discuss the matter with management and, if necessary, perform other procedures to conclude whether:

(a) A material misstatement of the other information exists;

(b) A material misstatement of the financial statements exists; or

(c) The auditor's understanding of the entity and its environment needs to be updated.

11.4 Responding When the Auditor Concludes that a Material Misstatement of the Other Information Exists

11.4.1 If the auditor concludes that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management:

(a) Agrees to make the correction, the auditor shall determine that the correction has been made; or

(b) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

11.4.2 If the auditor concludes that a material misstatement exists in other information obtained prior to the date of the auditor's report, and the other information is not corrected after communicating with those charged with governance, the auditor shall take appropriate action, including:

(a) Considering the implications for the auditor's report and communicating with those charged with governance about how the auditor plans to address the material misstatement in the auditor's report.

(b) Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

11.4.3 If the auditor concludes that a material misstatement exists in other information obtained after the date of the auditor's report, the auditor shall:

(a) If the other information is corrected, perform the procedures necessary in the circumstances; or

(b) If the other information is not corrected after communicating with those charged with governance, take appropriate action considering the auditor's legal rights and obligations, to seek to have the uncorrected material misstatement appropriately brought to the attention of users for whom the auditor's report is prepared.

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11.5 Responding When a Material Misstatement in the Financial Statements Exists or the Auditor's Understanding of the Entity and its Environment Needs to be Updated

If, as a result of performing the procedures discussed in 11.2, the auditor concludes that a material misstatement in the financial statements exists or the auditor's understanding of the entity and its environment needs to be updated, the auditor shall respond appropriately in accordance with the other SAs.

11.6 Reporting

The auditor's report shall include a separate section with a heading "Other Information", or other appropriate heading, when, at the date of the auditor's report:

(a) For an audit of financial statements of a listed entity, the auditor has obtained, or expects to obtain, the other information; or

(b) For an audit of financial statements of an unlisted corporate entity, the auditor has obtained some or all of the other information.

When the auditor's report is required to include an Other Information section, this section shall include:
(a) A statement that management is responsible for the other information;
(b) An identification of: (i) Other information, if any, obtained by the auditor prior to the date of the auditor's report; and (ii) For an audit of financial statements of a listed entity, other information, if any, expected to be obtained after the date of the auditor's report;
(c) A statement that the auditor's opinion does not cover the other information and, accordingly, that the auditor does not express (or will not express) an audit opinion or any form of assurance conclusion thereon;
(d) A description of the auditor's responsibilities relating to reading, considering and reporting on other information as required by this SA; and
(e) When other information has been obtained prior to the date of the auditor's report, either: (i) A statement that the auditor has nothing to report; or (ii) If the auditor has concluded that there is an uncorrected material misstatement of the other information, a statement that describes the uncorrected material misstatement of the other information.

When the auditor expresses a qualified or adverse opinion in accordance with SA 705 (Revised), Modifications to the Opinion in the Independent Auditor's Report the auditor shall consider the implications of the matter giving rise to the modification of opinion for the statement required.

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11.7 Reporting Prescribed by Law or Regulation

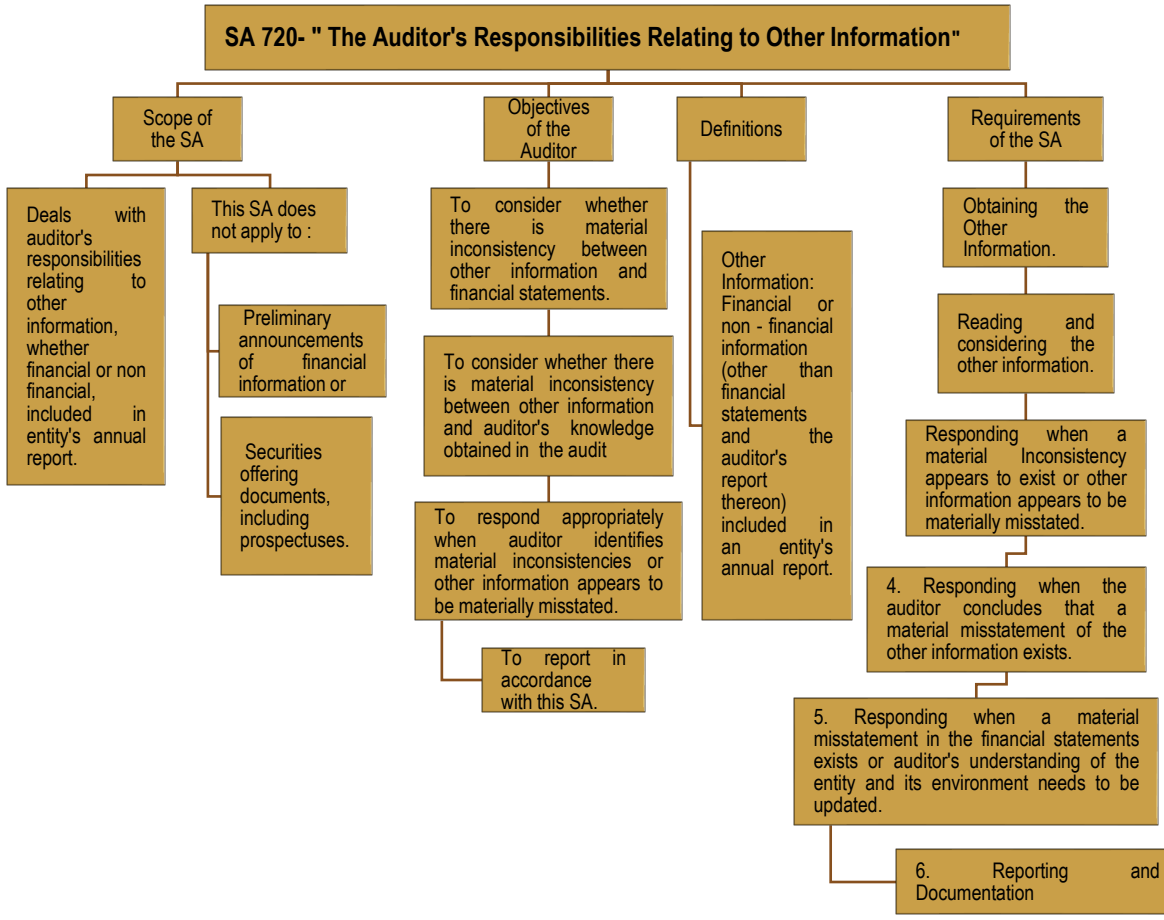
If the auditor is required by a relevant law or regulation to refer to the other information in the auditor's report using a specific layout or wording, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum:

(a) Identification of the other information obtained by the auditor prior to the date of the auditor's report;

(b) A description of the auditor's responsibilities with respect to the other information; and

(c) An explicit statement addressing the outcome of the auditor's work for this purpose.

(Note: Students are advised to refer Series of SA 700 on Audit Reporting and Conclusion for better understanding)



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12. DUTIES OF AUDITORS

Section 143 of the Companies Act, 2013 specifies the duties of an auditor of a company in a quite comprehensive manner. It is noteworthy that the scope of duties of an auditor has generally been extending over all these years.

1. Duty of Auditor to Inquire on certain matters: It is the duty of auditor to inquire into the following matters-

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) is reproduced below:

"The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor's Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider his duties under section 143(1)."

Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

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2. Duty to Sign the Audit Report: As per section 145 of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of 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 auditors' report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

3. Duty to comply with Auditing Standards: As per sub-section (9) of section 143 of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further, as per sub-section (10) of section 143 of the Act, the Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority. Students may note that until any auditing standards are notified, any standard, or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

4. Duty to audit report: As per sub-section (3) of section 143, the auditor's report shall also state–

(a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

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(g) whether any director is disqualified from being appointed as a director under sub-section (2) of the section 164;

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls;

(Note: Clause (i) of Sub-Section (3) of Section143 shall not apply to a private company:- (i) which is a one person company or a small company; or (ii) which has turnover less than rupees fifty crores as per latest audited financial statement and which has aggregate borrowings from banks or financial institutions or anybody corporate at any point of time during the financial year less than rupees twenty five crore)

(j) such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-

(1) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(2) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(3) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

(4) (i) Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

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(ii) Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

(iii) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.

(5) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

(6) Whether the company has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention].

Audit Trail means a step-by-step sequential record which provides evidence of the documented history of financial transactions to its source. An auditor can trace every step of, the financial data of a particular transaction right from the general ledger to its source document with the help of the audit trail.

Note: Students may refer Guidance note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013 for better understanding.]

The Companies (Amendment) Act, 2017 effective 12-09-2018 inserted Section 197(16) of the Companies Act, 2013 that requires as under:

"The auditor of the company shall, in his report under section 143, make a statement as to whether the remuneration paid by the company to its directors is in accordance with the provisions of this section, whether remuneration paid to any director is in excess of the limit laid down under this section and give such other details as may be prescribed".

As per Advisory issued by ICAI on 09-09-2019, the aforesaid reporting requirement for auditors of public companies needs to be covered in auditor's report under the Section "Report on Other Legal

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and Regulatory Requirements". Accordingly, auditors of public companies are advised to comply with the aforesaid reporting requirements in their auditor's reports.

5. Duty to report on frauds:

A. Reporting to the Central Government - As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the Rule 13 states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

(a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;

(b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;

(c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

(d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

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(e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(f) the report shall be in the form of a statement as specified in Form ADT-4.

B. Reporting to the Audit Committee or Board - Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub-rule (1) [i.e. less than ₹ 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

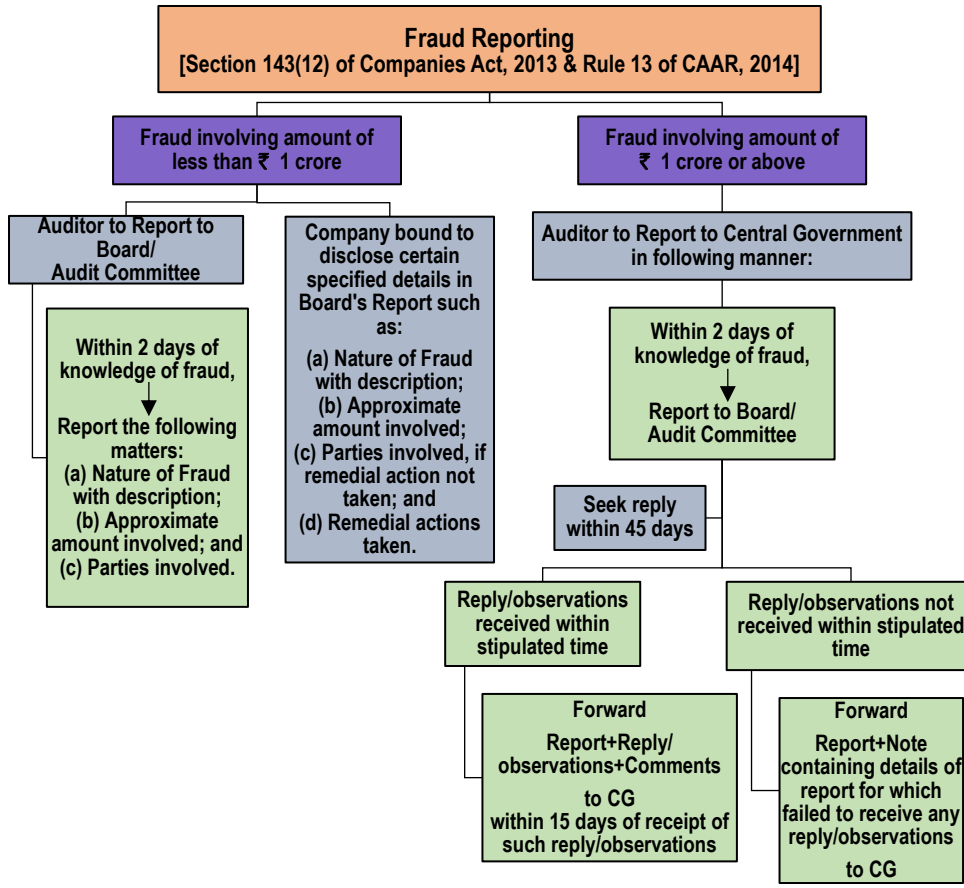
(a) Nature of Fraud with description;	(b) Approximate amount involved; and	(c) Parties involved.

C. Disclosure in the Board's Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the company is required to disclose in the Board's Report the following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year:

(a) Nature of Fraud with description;	(b) Approximate Amount involved;
(c) Parties involved, if remedial action not taken; and	(d) Remedial actions taken.

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Sub-section (13) of section 143 of the Companies Act, 2013 safeguards the act of fraud reporting by the auditor if it is done in good faith. It states that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

It is very important to note that the provisions regarding fraud reporting shall also apply, mutatis mutandis, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice does not comply with the provisions of sub-section (12) of section 143, he shall be liable to a penalty of five lakh rupees in case of a listed company and a penalty of one lakh rupees in case of any other company.

The auditor is also required to report under clause (xi) of paragraph 3 of Companies (Auditor's Report) Order, 2020 [CARO, 2020] on whether any fraud by the company or any fraud on the Company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

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The Auditing and Assurance Standards Board of the ICAI has issued the Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 to provide guidance to the members on this reporting requirement.

The definition of fraud as per SA 240 and the explanation of fraud as per Section 447 of the Companies Act, 2013 are similar, except that under section 447, fraud includes 'acts with an intent to injure the interests of the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.' However, an auditor may not be able to detect acts that have intent to injure the interests of the company or cause wrongful gain or wrongful loss, unless the financial effects of such acts are reflected in the books of account/financial statements of the company.

For example,

(i) an auditor may not be able to detect if an employee is receiving pay-offs for favoring a specific vendor, which is a fraudulent act, since such pay-offs would not be recorded in the books of account of the company;

(ii) if the password of a key managerial personnel is stolen and misused to access confidential/restricted information, the effect of the same may not be determinable by the management or by the auditor;

Therefore, the auditor shall consider the requirements of the SAs, in so far as it relates to the risk of fraud, including the definition of fraud as stated in SA 240, in planning and performing his audit procedures in an audit of financial statements to address the risk of material misstatement due to fraud.

[Note: Students may refer Guidance note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 for detailed knowledge.]

6. Duty to report on any other matter specified by Central Government: The Central Government may, in consultation with the National Financial Reporting Authority (NFRA), by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

As per the notification dated 29.03.2016, till the time NFRA is constituted, the Central Government may hold consultation required under this sub-section with the Committee chaired by an officer of the rank of Joint Secretary or equivalent in the MCA and the Committee shall have the representatives from the ICAI and Industry Chambers and also special invitees from the National Advisory Committee on Accounting Standards (NACAS) and the office of the C&AG. However, by virtue of notification dated 21st March 2018, in exercise of the powers conferred by sub-section (3)

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of section 1 of the Companies Act, 2013 (18 of 2013), the Central Government hereby appoints the 21st March, 2018 as the date on which the provisions of subsections (3) and (11) of section 132 of the said Act shall come into force.

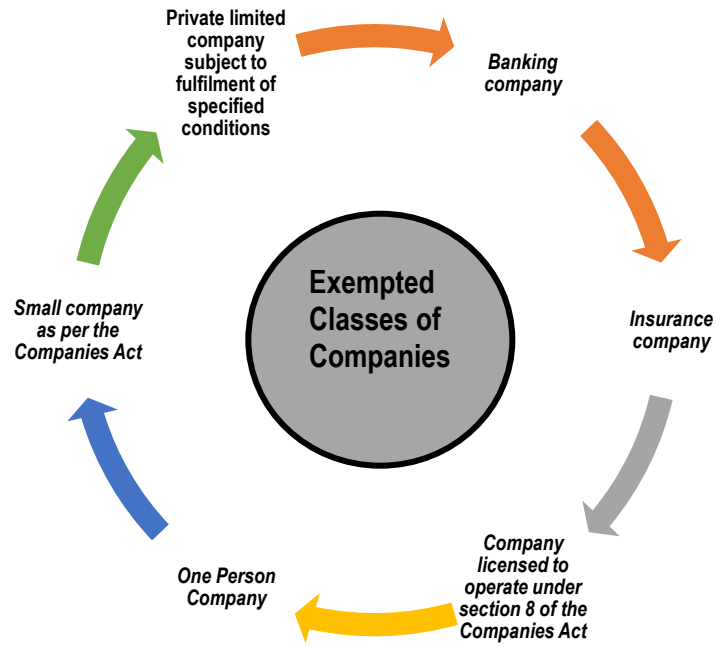
7. Duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor are discussed separately in this chapter.

8. Duty to state the reason for qualification or negative report: As per sub-section (4) of section 143, where any of the matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons there for.

12.1 Reporting Under CARO, 2020

In exercise of the powers conferred by section 143(11) of the Companies Act, 2013, the Central Government, after consultation with the National Financial Reporting Authority constituted under section 132 of the Companies Act, 2013, has issued the Companies (Auditor's Report) Order, 2020, (CARO, 20) dated 25th February, 2020.

1. **Applicability of the Order:** The CARO, 2020 is an additional reporting requirement. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013. However, the Order specifically **exempts the following classes of companies**:



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(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);

(ii) an insurance company as defined under the Insurance Act,1938 (4 of 1938);

(iii) a company licensed to operate under section 8 of the Companies Act;

(iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and

(v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year **as per the financial statements.**

2. **Auditor's report to contain matters specified in paragraphs 3 and 4 -** Every report made by the auditor under section 143 of the Companies Act, 2013 on the accounts of every company audited by him, to which this Order applies, for the financial year, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable.

It may be noted that the Order shall not apply to the auditor's report on consolidated financial statements except clause (xxi) of paragraph 3.

3. **Matters to be included in the auditor's report -** The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-

(i) (a) (A) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment;

(B) whether the company is maintaining proper records showing full particulars of intangible assets;

(b) whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

(c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the

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name of the company, if not, provide the details thereof in the format below:-

Description of property	Gross carrying value	Held in name of	Whether promoter, director or their relative or employee	Period held – indicate range, where appropriate	Reason for not being held in name of company*
-	-	-	-	-	*also indicate if in dispute

(d) whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;

(e) whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements;

(ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;

(b) whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

(iii) whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, if so-

(a) whether during the year the company has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other

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entity [not applicable to companies whose principal business is to give loans], if so, indicate-

(A) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to subsidiaries, joint ventures and associates;

(B) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties other than subsidiaries, joint ventures and associates;

(b) whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest;

(c) in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

(d) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;

(e) whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties, if so, specify the aggregate amount of such dues renewed or extended or settled by fresh loans and the percentage of the aggregate to the total loans or advances in the nature of loans granted during the year [not applicable to companies whose principal business is to give loans];

(f) whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in clause (76) of section 2 of the Companies Act, 2013;

(iv) in respect of loans, investments, guarantees, and security, whether provisions of sections 185 and 186 of the Companies Act have been complied with, if not, provide the details thereof;

(v) in respect of deposits accepted by the company or amounts which are deemed to be deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules made thereunder, where applicable, have been complied with, if not, the

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nature of such contraventions be stated; if an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not;

(vi) whether maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act and whether such accounts and records have been so made and maintained;

(vii) (a) whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

(b) where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute);

(viii) whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year;

(ix) (a) whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below:-

Nature of borrowing, including debt securities	Name of lender*	Amount not paid on due date	Whether principal or interest	No. of days delay or unpaid	Remarks, if any
	*lender wise details to be provided in case of defaults to banks, financial institutions and Government.				

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(b) whether the company is a declared wilful defaulter by any bank or financial institution or other lender;

(c) whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;

(d) whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;

(e) whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures, if so, details thereof with nature of such transactions and the amount in each case;

(f) whether the company has raised loans during the year on the pledge of securities held in its subsidiaries, joint ventures or associate companies, if so, give details thereof and also report if the company has defaulted in repayment of such loans raised;

(x) (a) whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;

(b) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance;

(xi) (a) whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;

(b) whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;

(c) whether the auditor has considered whistle-blower complaints, if any, received during the year by the company;

(xii) (a) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability;

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(b) whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;

(c) whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof;

(xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards;

(xiv) (a) whether the company has an internal audit system commensurate with the size and nature of its business;

(b) whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor;

(xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with;

(xvi) (a) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 (2 of 1934) and if so, whether the registration has been obtained;

(b) whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934;

(c) whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria;

(d) whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group;

(xvii) whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses;

(xviii) whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors;

(xix) on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities

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existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date;

(xx) (a) whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VII to the Companies Act within a period of six months of the expiry of the financial year in compliance with second proviso to sub-section (5) of section 135 of the said Act;

(b) whether any amount remaining unspent under sub-section (5) of section 135 of the Companies Act, pursuant to any ongoing project, has been transferred to special account in compliance with the provision of sub-section (6) of section 135 of the said Act;

(xxi) whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements, if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

4. Reasons to be stated for unfavourable or qualified answers-

(a) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.

(b) Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.

13. ILLUSTRATIVE AUDIT REPORTS

Example 1- Illustration of Emphasis of Matter Para

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other

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explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at *(location of branches)*)[13].

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *give a true and fair view,* in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the *ICAI's Code of Ethics and the provisions of the Companies Act, 2013*, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SA 701].

Other Matter

The financial statements of ABC Company for the year ended March 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised) given in Auditing Pronouncement.]

Auditor's Responsibilities for the Audit of the Financial Statements

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[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised)].

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised)].

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

Example 2- Illustration of Emphasis of Matter in a situation when the business of one of the Indian branch office of an existing foreign company- ABC Limited is being transferred by way of slump sale to another newly incorporated subsidiary company in India- XYZ Private Limited

Relevant Note given by the management in the financial statements of India Branch Office of ABC Limited

"During the year, ABC Limited ('the Company') has incorporated a private limited company ('XYZ Private Limited') in India for the purpose of furtherance of the Company's objectives and has entered into a Business Transfer Agreement dated October 5, 2024 with XYZ Private Limited for transfer of all assets and liabilities alongwith the business of India Branch Office to XYZ Private Limited on going concern basis effective April 01, 2024. Further, the Reserve Bank of India (RBI) vide letter No. ……dated December 22, 2024 has also granted approval for transfer of assets and liabilities and business of India Branch Office to XYZ Private Limited.

ABC Limited has confirmed that it shall provide continuing financial and operational support to its Branch Office in India for its operations during the transitional period and loss incurred post the date of transfer of business to XYZ Private Limited, if any, shall be borne by ABC Limited

The current year financial statements of India Branch Office have been prepared on the basis that the Branch Office does not continue to be a going concern, and all its assets are carried in the books of accounts at the values likely to be recovered at the time of closure of operations, to the extent ascertainable at the time of preparation of these financial statements".

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INDEPENDENT AUDITOR'S REPORT

To the Members of India Branch Office of ABC Limited

Report on the Audit of the Standalone Financial Statements

Opinion

We have audited the standalone financial statements of India Branch Office of ABC Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *give a true and fair view,* in conformity with the accounting principles generally accepted in India, of the state of affairs of the India Branch Office of the Company as at March 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the *ICAI's Code of Ethics and the provisions of the Companies Act, 2013*, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note XX regarding India Branch Office management's intention to close the operations of the Branch Office subject to regulatory approvals. Accordingly, the financial statements have been prepared on the basis that the India Branch Office does not continue to be a going concern, and provisions have been made in the books of account for the losses arising or likely to arise on account of closure of operations including the losses on the realizability of current assets.

Our opinion is not modified in respect of this matter.

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Example 3- Qualified Opinion

Relevant Notes given by the management in the financial statements of ABC Limited

(a) During the year, the management circulated request for confirmation to key vendors of maintenance expenses and has written-back the liabilities recorded in earlier years of ₹ 2 crores that have not been claimed by these vendors and have also not been responded to management's request for confirmation. The management is confident that the balances are no longer payable and that no further adjustments are required to the financial statements in this regard.

(b) During the year, the management has undertaken detailed assessment regarding advances of ₹____ paid to certain project managers including ₹____ paid during earlier years. The Company has incurred expenses on account of travel expense at various sites in cash and has closing balance of ₹ 1.75 crores against which management has obtained confirmation from respective project managers for balances aggregating ₹ 0.65 crores and has provided balance amount of ₹ 1.1 crores as provision for doubtful advances. The management is confident that the expenditure incurred is towards business operations of the Company and that no further adjustments are required to the financial statements in this regard.

Report on the Audit of the Standalone Financial Statements

Qualified Opinion

We have audited the standalone financial statements of ABC Limited ("the Company"), which comprise the balance sheet as on March 31, 20X1, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *subject to the matters discussed in Basis for Qualified Opinion paragraph below, the consequential impact, if any, whereof is not quantifiable*, *give a true and fair view,* in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as on March 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Qualified Opinion

(a) As stated in Note XX of the financial statements, the management has during the year circulated request for confirmation to key vendors of maintenance expenses and written-back

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the liabilities recorded in earlier years of ₹ 2 crores considering that these balances have not been claimed by these vendors and they have also not responded to management request for confirmation. In the absence of balance confirmation of these vendors, we are unable to comment upon such write back of ₹2 crores and any further adjustments that may be required to the financial statement in this regard.

(b) Attention is invited to Note____ which explains management assessment regarding advances of ₹____ paid to certain project managers including ₹____ paid during earlier years. The Company has incurred expenses on account of travel at various sites in cash and has closing balance of ₹ 1,75 crores against which management has obtained confirmation from respective project managers for balances aggregating ₹ 0.65 crores and has provided balance amount of ₹ 1.1 crores as provision for doubtful advances. Further, for such transactions, the Company has not complied with provision for deduction of taxes at source.

We strongly recommend that management should undertake these transactions through banking channels and in the absence of any confirmations, we are unable to confirm the completeness of expenses as at year- end and consequential adjustment required to closing tax liabilities and interest thereupon, if any.

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the *ICAI's Code of Ethics and the provisions of the Companies Act, 2013*, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion, except for the matters discussed above.

Note: Students are advised to refer Illustrations of Independent Auditor's Reports on Financial Statements given in SA 700.

Illustration 1: An auditor's report on financial statements of a listed entity prepared in accordance with a fair presentation framework

Illustration 2: An auditor's report on consolidated financial statements of a listed company prepared in accordance with a fair presentation framework

Illustration 3 – Auditor's Report on Financial Statements of an Unlisted Company Prepared in Accordance with a Fair Presentation Framework

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Illustration 4 – Auditor's Report on Financial Statements of a Non Corporate Entity Prepared in Accordance with a Fair Presentation Framework

Illustration – Auditor's Report on Financial Statements of Non Corporate Entity Prepared in Accordance with a General Purpose Compliance Framework

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity, other than a listed company under the Companies Act 2013, required by law or regulation. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the Financial Reporting Framework (XYZ Laws) of Jurisdiction X (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- The auditor has no other reporting responsibilities required under local law.

Opinion

We have audited the financial statements of ABC & Associates (the entity), which comprise the balance sheet as at March 31, 20X1, and the Profit and Loss Account (and the cash flow statement)[1] for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

[1] Where applicable.

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In our opinion, the accompanying financial statements of the entity are prepared, in all material respects, in accordance with XYZ Laws.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the entity in accordance with the ethical requirements that are relevant to our audit of the financial statements, and we have fulfilled our other responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements[2]

Management is responsible for the preparation of the financial statements in accordance with XYZ Law and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the entity's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the entity's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

[2] Or other terms that are appropriate in the context of the legal framework of the particular entity.

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As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[3]

  Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the entity to cease to continue as a going concern.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Illustration – Qualified Opinion due to a Material Misstatement of the Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company (registered under the Companies Act, 2013) using a fair presentation framework.
- The financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.[4]

[3] This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.
[4] SA 210, *Agreeing the Terms of Audit Engagements*

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- Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

Report on the Audit of the Standalone Financial Statements[5]

Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20XX, and the statement of Profit and Loss, *(statement of changes in equity)*[6] and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at *(location of branches)*)[7].

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at ₹ XXX. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from the Accounting Standards prescribed under section 133 of the Companies Act, 2013. The Company's records indicate that, had management stated the inventories

[5] The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.
[6] As may be applicable.
[7] As may be applicable.

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at the lower of cost and net realizable value, an amount of ₹ xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by ₹ xxx, and income tax, net income and shareholders' funds would have been reduced by ₹ xxx, ₹ xxx and ₹ xxx, respectively.

We conducted our audit in accordance with Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ICAI's Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Note : Students are advised to refer Illustrations of Auditor's Reports with Modifications to the Opinion given in SA 705.

- Illustration 2: An auditor's report containing an adverse opinion due to a material misstatement of the consolidated financial statements.
- Illustration 3: An auditor's report containing a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding a foreign associate.
- Illustration 4: An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements.

Illustration – Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about Multiple Elements of the Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of financial statements of an entity other than a company incorporated under the Companies Act, 2013, using a fair presentation framework. The audit is not a group audit (i.e., SA 600, does not apply).*
- *The financial statements are prepared by management of the entity in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*

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- *The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements, that is, the auditor was also unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.*
- *The relevant ethical requirements that apply to the audit are ICAI's Code of Ethics and applicable law/regulation*
- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *A more limited description of the auditor's responsibilities section is required.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under relevant law/ regulation.*

Report on the Audit of the Financial Statements[8]

Disclaimer of Opinion

We were engaged to audit the financial statements of ABC & Associates ("the entity"), which comprise the balance sheet as at March 31, 20XX, the statement of Profit and Loss, *(the statement of changes in equity)*[9] and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the entity. Because of the significance of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after March 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 20X0 and 20X1, which are stated in the Balance Sheets at ` xxx and ` xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the Balance Sheet at a total amount

[8] The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.
[9] Where applicable.

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of ` xxx as on March 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of Profit and Loss (*and statement of cash flows)*[10].

Auditor's Responsibilities for the Audit of the Financial Statements

Our responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report. However, because of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the entity in accordance with the ethical requirements in accordance with the requirements of the Code of Ethics issued by ICAI and the ethical requirements as prescribed under the laws and regulations applicable to the entity.

Illustration of an Auditor's Report that Includes a Key Audit Matters Section, an Emphasis of Matter Paragraph, and an Other Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of financial statements of a listed company (registered under the companies Act, 2013) using a fair presentation framework.*
- *The financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*
- *The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.*
- *The relevant ethical requirements that apply to the audit are those of the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.*
- *Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).*
- *Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent*

[10] Where applicable.

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event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.

- *Key audit matters have been communicated in accordance with SA 701.*
- *Corresponding figures are presented, and the prior period's financial statements were audited by a predecessor auditor. The auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and has decided to do so.*
- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.*

Report on the Audit of the Standalone Financial Statements[11]

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at *(location of branches)*)[12].

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *give a true and fair view,* in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the *ICAI's Code of Ethics and the provisions of the Companies Act, 2013*, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

[11] [1] The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.
[12] As may be applicable

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Emphasis of Matter[13]

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Illustration of an Auditor's Report Containing a Qualified Opinion Due to a Departure from the Applicable Financial Reporting Framework and that Includes an Emphasis of Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- *Audit of a complete set of financial statements of an company other than a listed company (registered under the Companies Act, 2013) using a fair presentation framework..*
- *The financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*
- *A departure from the applicable financial reporting framework resulted in a qualified opinion.*
- *The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.*
- *Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).*
- *Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.*
- *The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.*
- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.*

[13] As noted in paragraph A16, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph.

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Report on the Audit of the Standalone Financial Statements[14]

Qualified Opinion

We have audited the standalone financial statements of ABC Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at *(location of branches)*)[2].

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the aforesaid financial statements present fairly, in all material respects, or *give a true and fair view* in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Qualified Opinion

The Company's short-term marketable securities are carried in the statement of financial position at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from the Accounting Standards prescribed in section 133 of the Companies Act, 2013. The Company's records indicate that had management marked the marketable securities to market, the Company would have recognized an unrealized loss of ₹xxx in the statement of comprehensive income for the year. The carrying amount of the securities in the statement of financial position would have been reduced by the same amount at March 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by ₹xxx, ₹xxx and ₹xxx, respectively.

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ICAI's Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

[14] The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

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Emphasis of Matter – Effects of a Fire

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Note: Students may refer to the remaining paras of Audit Report like Key Audit Matters para etc., from the illustrative format given above.

Key Takeaways

- SA 700 deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.
- The objectives of the auditor in accordance with SA 700 are to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained and to express clearly that opinion through a written report.
- As per SA 700, the auditor's report shall be in writing and shall include the basic elements which ordinarily includes in case of auditors' Report for audits conducted in accordance with Standards on Auditing
- SA 701 deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.
- The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.
- It is mandatory to communicate key audit matters in audits of complete sets of general-purpose financial statements of listed entities in accordance with SA 701.
- SA 705 deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700, the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.
- The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate,

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are material, but not pervasive, to the financial statements or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

- The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
- The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.
- SA 706 deals with additional communication in the auditor's report when the auditor considers it necessary to draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements or draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
- "Emphasis of Matter" paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.
- "Other Matter Paragraph" is a paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
- SA 710 deals with the auditor's responsibilities regarding comparative information in an audit of financial statements.
- Comparative information refers to the amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.
- SA 720 deals with the auditor's responsibilities relating to other information, whether financial or non-financial information (other than financial statements and the auditor's report thereon), included in an entity's annual report.

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- SA 720 requires the auditor to read and consider the other information because other information that is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit may indicate that there is a material misstatement of the financial statements or that a material misstatement of the other information exists, either of which may undermine the credibility of the financial statements and the auditor's report thereon. Such material misstatements may also inappropriately influence the economic decisions of the users for whom the auditor's report is prepared.

FOR SHORTCUT TO ENGAGEMENT & QUALITY CONTROLS STANDARDS WISDOM: SCAN ME !



TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Under the applicable Standards on Auditing, in what circumstances does the report of the statutory auditor require modifications? What are the types of modifications possible to the said report?*
2. *Write a short note on Emphasis of matter paragraph in Audit Reports.*
3. *Write a short note on Certificate for Special Purpose vs. Audit Report.*
4. *Compare and explain the following:*
   - *(i) Reporting to Shareholders vs. Reporting to those Charged with Governance*
   - *(ii) Audit Qualification vs. Emphasis of Matter.*
5. *"When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion*

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section." As an expert you are required to brief the special considerations required for expressing:

(a) Qualified Opinion;

(b) Adverse Opinion and

(c) Disclaimer of Opinion.

6. *ADKS & Co. LLP are the newly appointed statutory auditors of PKK Ltd. During the course of audit, the statutory auditors have come across certain significant observations which they believe could lead to material misstatement of financial statements. Management has a different view and does not concur with the view of the statutory auditors. Considering this the statutory auditors are determining as to how to address these observations in terms of their reporting requirement. Please advise.*

7. *KPI Ltd. is a joint venture of KPI Inc., a company based in US, and OPQ Ltd., a company based in Japan (hereinafter referred to as 'JV partners'). KPI Ltd. was registered in India and is operating as a marketing support company for KPI Inc. All the costs of KPI Ltd. are incurred in India and entire revenue of KPI Inc. is generated in USD. The entire funding requirements of KPI Ltd. are taken care of by the JV partners. Since KPI Ltd. is based in India, hence it is also required to get its financial statements audited.*

   The company appointed new auditors for the audit of the financial statements for the year ended 31 March 2024 after doing all appointment formalities wherein auditors are required to ensure compliance with Standards on Auditing and Internal Standards on Auditing.

   As an expert you are required to advise the auditor about the requirements regarding the auditor's report for audits conducted in accordance with both Standards on Auditing issued by ICAI and International Standards on Auditing.

8. *TUV Ltd. is a company engaged in the business of manufacturing spare parts. Saroj & Associates are the statutory auditors of the company for the FY 2023-24. During the audit, CA Saroj noticed that the company had a major customer, namely, Korean Mart from South Korea. Owing to an outbreak of war and subsequent destruction leading to government ban on import and export in South Korea, the demand from Korean Mart for the products of TUV Ltd. ended for an unforeseeable time period. When discussed with the management, CA Saroj was told that the company is in the process of identifying new customers for their products. CA Saroj understands that though the use of going concern assumption is appropriate, but a material uncertainty exists with respect to the identification of new customers. This fact is*

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duly reflected in the financial statements of TUV Ltd. for FY 2023-24. How should CA Saroj deal with this matter in the auditor's report for the FY 2023-24?

9. *Sun Moon Ltd. is a power generating company which uses coal as raw material for its power generating plant. The company has been allotted coal blocks in the state of Jharkhand and Odisha. During the FY 2023-24, a scam regarding allotment of coal blocks was unveiled leading to a ban on the allotment of coal blocks to various companies including Sun Moon Ltd. This happened in the month of December 2023 and as such entire power generation process of Sun Moon Ltd, came to a halt in that month. As a result of such ban, and the resultant stoppage of the production process, many key managerial personnel of the company left the company. There were delays in the payment of wages and salaries and the banks from whom the company had taken funds for project financing also decided not to extend further finance or to fund further working capital requirements of the company.*

   Further, when discussed with the management, the statutory auditor understood that the company had no action plan to mitigate such circumstances. Further, all such circumstances were not reflected in the financial statements of Sun Moon Ltd. What course of action should the statutory auditor of the company consider in such situation?

10. *CA Omkar is the statutory auditor of Sabhyata Ltd. for the FY 2023-24. The company is engaged in the business of manufacture of floor tiles. During the audit, CA Omkar obtained certain audit evidence which were not consistent with the affirmation made in the financial statements. Discuss as to how CA Omkar should deal with the situation in the auditor's report.*

11. Neptune Ltd. is a company that holds significant investments in a portfolio of equity securities. Due to a decline in market value, the company's investments have suffered a notable diminution in value. For the financial year ended 31st March 2023, the audit report of Neptune Ltd. included a qualification regarding the non-provision of ₹ 70 lakh for the diminution in the value of these investments. As the auditor for the financial year 2023-24, how would you report in the following situations:

   (i) If the company does not make a provision for the diminution in the value of investments in the year 2023-24?

   (ii) If the company makes an adequate provision for the diminution in the year 2023-24?

12. During the course of audit of PEC Limited, CA Guru has reason to believe that a fraud involving ₹ 75 lakhs has been committed in the company by its employees. Is CA Guru

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under statutory obligation to report the above matter to Central government by filing prescribed form on MCA Portal? How should he proceed to report above said matter?

13. *Discuss the reporting responsibilities of statutory auditor in the following situations for year 2023-24 under CARO, 2020:*

    (i) *In the financial year 2023-2024, Candy Ltd. decided to upgrade its registered office, located at a prime spot in Bangalore. As a part of this upgrade, the company sought to acquire an adjacent plot of land owned by Mr. Sidhant, who is also a director of Candy Ltd. Initially hesitant to sell, Mr. Sidhant was persuaded to transfer his property to the company in exchange for a larger plot owned by Candy Ltd. This plot, located on a nearby street, is double the size of Mr. Sidhant's land.*

    Satisfied with the exchange, Mr. Sidhant agreed to transfer the property, and the exchange was formalised in a deed executed by the company's authorised representatives and Mr. Sidhant. The registration of the properties was completed by December 31, 2023.

    (ii) *On 15th May, 2023, a TDS survey was carried out in premises of SSO Industries Limited in accordance with the provisions of the Income Tax Act, 1961.The survey team pointed out certain lapses regarding non-deduction of tax at source and subsequently Deputy Commissioner of Income Tax (TDS) raised a demand of ₹ 25 lacs on the company treating it as "assessee in default". The company has not deposited demand raised and filed appeal against impugned order on 01st March, 2024 under e-appeals scheme with JCIT (Appeals).*

14. *Fancy Limited is a foreign company providing software support services having its Branch Office at Delhi. During the year 2023-24, Fancy Limited incorporated a subsidiary Nancy Private Limited in Gurgaon. For furtherance of objectives, Fancy Limited entered into a Business Transfer Agreement dated 5th October 2023 with Nancy Private Limited for transfer of all assets and liabilities along with the business of Delhi Branch to Nancy Private Limited on a going concern basis effective from 01st April, 2023. Further necessary approval from regulatory authorities is also received on 20th December, 2023 for such transfer. Fancy Limited promised that it shall provide continuing financial and operational support to Delhi Branch and further confirmed that any losses incurred post the date of transfer shall be borne by Fancy Limited.*

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During the year 2023-24, Delhi Branch of Fancy Limited have prepared its financial statements on the basis that the Branch Office does not continue to be a going concern and all its assets are carried in the books of accounts at the values likely to be recovered at the time of closure of operations, to the extent ascertainable at the time of preparation of the financial statements. Delhi Branch has incorporated above matter in detailed form in Note XX to the financial statements.

You are the statutory auditor of Delhi Branch of Fancy Limited for the financial year 2023-24. According to you, Delhi Branch has correctly disclosed about the matter in Note XX to the Financial Statements regarding management's intention to close the operations of the branch office. Further you have obtained sufficient appropriate audit evidence concerning audit and on the verge of finalization of audit report.

Draft a suitable opinion paragraph and basis thereof in the given case along with disclosure of Note XX with suitable place in audit report in terms of relevant auditing standard.

15. *You are appointed as a Statutory Auditor of SDA Limited for the year 2023-24 in the place of CA T. During the audit you found an order dated 01.05.2023 under section 148 of the Income-tax Act, 1961 wherein tax of ₹ 50 lakhs were demanded owing to undisclosed cash sales of ₹ 150 lakhs for the financial year 2020-21 which was accepted by the company and the applicable tax was paid by the Company during the year 2023-24. The company has not recorded such undisclosed income in their books of account during the year 2023-24. On further inquiring the matter with CA T, you came to know that CA T resigned due to non-recording of such transaction by the company. Is there any reporting responsibility cast on you regarding the above matters under CARO, 2020 for the year 2023-24?*

16. *While conducting audit of CGX Limited, a listed company, for year 2023-24, CA Srishti notices that company has extinguished following material liabilities unilaterally without entering into settlement with creditors and reported these amounts as gains under "Other income". The details in this respect are as under: -*

S. No.	Particulars	Amount involved
(i)	Liabilities for purchases of raw material were written back on account of poor quality of raw material and difference in rates	₹ 3.50 crores

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(ii)	*Liabilities for capital goods were written back on account of defects in machinery supplied by creditors*	*₹ 2.00 crores*

The management is of the opinion that these dues are no longer payable. Therefore, retaining these liabilities on financial statements would lead to overstatement of liabilities. Extinguishment of liabilities was made by company in accordance with normal trade practices and outstandings were written back after stopping dealing with such creditors. She wanted to send external confirmation requests to such creditors. However, management informed her that sending such requests may be used by creditors as proof of existence of liability.

She is contemplating inclusion of above matters under "Key audit matters" in audit report. Analyse the situation threadbare.

17. *Naresh & Co., Chartered Accountants, have been appointed Statutory Auditors of Suchi Ltd. for the F.Y. 2023-24. The audit team has completed the audit and is in the process of preparing audit report. The management of the company has also prepared draft annual report.*

The audit in-charge was going through the draft annual report and observed that the company has included an item in its Annual Report indicating a downward trend in market prices of key commodities/raw material as compared to previous year. However, the actual profit margin of the company as reported in financial statements has gone in the reverse direction. The Audit Manager discussed this issue with a partner of the firm who in reply said that auditors are not covered with such disclosures made by the management in its annual report, it being the responsibility of the management.

Do you think that the partner is correct in his approach on this issue?

Discuss the Auditor's duties with regard to reporting with reference to the relevant Standards on Auditing.

18. *Nandini Ltd., a chemical manufacturing company, having its factory located at Kanawali Village, for the year 2023-24 appointed Vasu & Co. as their statutory auditors. During the audit, Vasu & Co. identified that Nandini Ltd. received a show cause notice from the National Green Tribunal based on the investigation performed by the regional forest department for violating environmental laws. Upon gathering a further understanding of the said matter, it was identified that Nandini Ltd. was dumping toxic solid waste, without treating it, on the nearby grounds, and because of this, the nearby water bodies were getting polluted. Based on the preliminary investigation carried out by the regional forest department under the directions of the National Green Tribunal,*

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it was identified that these practices were carried out since 2009 and a lot of damage has been done to the environment by Nandini Ltd.. A show cause notice was already issued to Nandini Ltd. by the National Green Tribunal for levying the penalty of an amount of ₹ 700 crore. The unaudited profit for the financial year 2022-23 of Nandini Ltd. was ₹ 49 crore and the unaudited turnover was ₹ 120 crore. Upon inquiry it was identified that Nandini Ltd. has disclosed this matter in the financial statements by way of footnote, the extract of which is provided below:

"The company has received a show cause notice from the National Green Tribunal for some potential violation of environmental laws and the company's legal department has assessed and found that the judgment would be in favour of the company. Accordingly, no provision has been created for such notices."

In the light of the above scenario kindly provide what should be the appropriate option for the statutory auditor of the company to report this matter.

19. BPMR and Associates, a renowned audit firm in the field of CA practice for the past three decades, was appointed to conduct the statutory audit of Rexlon Ltd., an unlisted company engaged in the business of paper manufacturing. The firm decided to commence the audit for the recently concluded financial year. After making significant progress in the audit, the auditors made the following observations:

Observation 1: The management had disclosed in the financials that, during the year, one of the warehouses of the Company was affected due to a major flood. As a result of the same, the Company had incurred some losses. But the management was of the view that it was not material.

Observation 2: Due to the flood, few records maintained by the Company with respect to a particular transaction was completely destroyed and there was no duplicate record maintained by the Company. However, those details were not pervasive, but material.

You are required to advise whether BPMR and Associates should report Observation 1 and 2 in its audit report? If so, under which heading should it be reported?

Answers to Test Your Understanding

1. Such matters are in nature of auditor's responsibilities and are stated in *"The Auditor's Responsibilities for the Audit of the Financial Statements"* section of the auditor's report in accordance with SA 700. Communication of significant audit findings and deficiencies identified in internal control to those charged with governance is one of important responsibilities of auditor.

   Such communication assists those charged with governance in fulfilling their responsibility to oversee the financial reporting process and in fulfilling their oversight responsibilities.

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2. The above matter is in nature of Key audit matter and should be stated under heading "Key audit matters" in audit report. Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

   SA 701 states that the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, significant auditor judgments relating to areas in the financial statements that involved significant management judgment including accounting estimates that have been identified as having high estimation uncertainty be taken into account.

   The above described matter relates to revenue recognition and creation of complexities requiring judgment in revenues. Further, the description also describes how the matter was addressed by auditors by performing various audit procedures in accordance with SA 701.

3. In accordance with SA 706, Emphasis of Matter Paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

   As per SA 706, the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to: -

   (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements or

   (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

   Further, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor would not be required to modify the opinion in accordance with SA 705 as a result of the matter.

   In the given situation, auditor has relied upon management representation letter only. He has not performed any other audit procedures like verifying contracts with customers, status of arbitration proceedings etc. Since management representations by themselves do not constitute sufficient appropriate evidence, performing necessary audit procedures may lead

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auditor to conclude that modification in opinion is necessary. In such circumstances, matter cannot be included in Emphasis of matter Paragraph.

Therefore, auditor should form his opinion by performing necessary audit procedures and obtaining sufficient appropriate evidence. It is only when he concludes that modification of opinion is not required as a result of said matter in terms of SA 705, the said matter may be included in Emphasis of Matter paragraph.

Answers to Theoretical Questions

1. Refer Para 5.

2. Refer Para 6.

3. **Certificate for Special Purpose vs. Audit Report:** A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. The term 'certificate' is, therefore, used where the auditor verifies the accuracy of facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain figures and is in a position to vouch safe their accuracy as per his examination of documents and books of account. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill. The 'report' involves expression of opinion which may differ from one professional to another. There is no question of exactitude in case of a report since the information contained therein is based on estimates and involves judgement element.

4. **(i)** **Reporting to Shareholders vs. Reporting to those Charged with Governance:**

REPORT	
Reporting to Shareholders	**Reporting to those Charged with Governance**
• Section 143 of the Companies Act, 2013 deals with the provisions relating to reporting to Shareholders. Thus, it is a	• Standard on Auditing 260 deals with the provisions relating to reporting to those Charged with Governance.

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Statutory Audit Report which is addressed to the members.	
• Statutory Audit Report is on true and fair view and as per prescribed Format.	• It is a reporting on matters those charged with governance like scope of audit, audit procedures, audit modifications, etc.
• Statutory Audit Reports are in public domain.	• Reporting to those Charged with Governance is an internal document i.e., private report.

(ii) Audit Qualification vs. Emphasis of Matter:

REPORT	
Audit Qualification	**Emphasis of Matter**
• Standard on Auditing 705 "Modifications to the Opinion in the Independent Auditor's Report", deals with the provisions relating to Audit Qualification.	• Standard on Auditing 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" deals with the provisions relating to Emphasis of Matter.
• Audit Qualifications are modifications to the opinion of the Auditors opinion where the auditor concludes that there is a material misstatement in the financial statement due to which the modification to the opinion of the auditor is necessary.	• Emphasis of Matter is a paragraph which is included in auditor's report to draw users' attention to important matter(s) which are already disclosed in Financial Statements and are fundamental to users' for understanding of Financial Statements. • The Emphasis of matter pre-supposes that there is Sufficient Appropriate audit evidence, and the matter has been correctly disclosed.
• Audit Qualifications are given when auditor has concluded that the financial statements are materially misstated or do not confirm to the financial reporting framework. Depending upon the	• Emphasis of Matter is a paragraph which is issued when the auditor feels that it is necessary to invite attention to a particular mater which has been appropriately disclosed in the financial

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nature of material misstatement being pervasive or otherwise the appropriate type of modified opinion is issued.	statements which in the opinion of the auditor is necessary for better understanding of the financial statement.

5. Refer Para 5.8

6. As per SA 705 (Revised), if the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in his report.

The auditor in such a case needs to determine the modification as follows:

(i) Qualified Opinion: The auditor shall express a qualified opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

(ii) Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements

(iii) Disclaimer of Opinion: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

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If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

7. Refer Para 3.4

8. As per SA 570, "Going Concern", loss of a major market or a key customer is one of the operating indicators that may cast significant doubt on the company's ability to continue as a going concern.

In the present case, TUV Ltd. has a key customer in South Korea from which the demand for its products has ended on account of outbreak of war, subsequent destruction and government ban on import and export in South Korea. Further, the company has not yet identified new customers and is in the process of doing the same. As such, the identification of new customers is a material uncertainty that cast a significant doubt on the company's ability to continue as a going concern.

However, this matter is duly disclosed by the management of TUV Ltd. in the financial statements for the year ended 31-03-2024.

As such, considering that the going concern assumption is appropriate but a material uncertainty exists with respect to identification of new customer, CA Saroj should:

(1) Express an unmodified opinion and

(2) Include in his audit report, a separate section under the heading "Material Uncertainty Related to Going Concern" to:

  (i) Draw attention to the note in the financial statements that discloses the matters and

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

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Thus, CA Saroj should deal with this matter in his auditor's report in the above mentioned manner.

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

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

When the use of Going Concern Basis of Accounting Is Inappropriate i.e. if the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

Also, when adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements the auditor shall:

(i) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised); and

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

In the present case, the following circumstances indicate the inability of Sun Moon Ltd. to continue as a going concern:

- Ban on the allotment of coal blocks
- Halt in power generation
- Key Managerial Personnel leaving the company.
- Banks decided not to extend further finance and not to fund the working capital requirements of the company.
- Non availability of sound action plan to mitigate such circumstances.

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Therefore, considering the above factors it is clear that the going concern basis is inappropriate for the company. Further, such circumstances are not reflected in the financial statements of the company. As such, the statutory auditor of Sun Moon Ltd. should:

(1). Express an adverse opinion in accordance with SA 705 (Revised) and

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

The auditor is also required to report as per clause (xix) of CARO 2020 that on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date.

10. SA 705 (Revised) deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700, the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Further, the auditor shall modify the opinion in the auditor's report when the auditor concludes that based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

In the present case, during the course of audit, CA Omkar obtained certain audit evidence which were not consistent with the affirmation made in the financial statements. Therefore, CA Omkar should modify his report in accordance with SA 705- "Modifications to The Opinion In The Independent Auditor's Report".

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CA Omkar should issue either a qualified opinion or an adverse opinion depending upon the circumstances of the case:

(a) CA Omkar shall express a qualified opinion when, having obtained sufficient appropriate audit evidence, he concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements

(b) CA Omkar shall express an adverse opinion, when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Thus, since CA Omkar has obtained audit evidence which is inconsistent with the affirmations made in the financial statement, CA Omkar should modify his opinion as per the circumstances of the case.

11. ***As per SA 710, "Comparative Information – Corresponding Figures and Comparative Financial Statements", when the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.***

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

(i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

(ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant case, if Neptune Ltd. does not make a provision for a diminution in the value of investment to the extent of ₹70 lakh, the auditor will have to modify his report for both the current and previous year's figures as mentioned above. If, however, the provision is made, the auditor need not refer to the earlier year's modification.

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12. *As per section 143(12) of the Companies Act, 2013 read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹1 crore or above, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as prescribed.*

In the given case, CA Guru has reason to believe that a fraud involving ₹75 lakhs has been committed in the company by its employees. Therefore, he is under no statutory obligation to report this matter to Central Government by filing prescribed Form (ADT-4) on MCA portal.

In case of a fraud involving lesser than the specified amount [i.e. less than ₹1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed. Besides, auditor has obligation to report matters pertaining to fraud under clause (xi) of paragraph 3 of CARO, 2020.

13. (i) *The auditor is required to report the transaction as per Clause (xv) of Paragraph 3 of the CARO, 2020 which states that whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of the Companies Act have been complied with.*

Further, as per Clause (xiii) of Paragraph 3 of the CARO, 2020, auditor should report whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards.

In the given situation, Candy Ltd. has entered into non-cash transactions with one of the directors, Mr. Sidhant during the year, by transferring the property (by Mr. Sidhant) in favour of the Company in a deed of exchange of a site owned by the company.

Thus, the auditor is required to report the same as per Clause (xv) and Clause (xiii) of Paragraph 3 of the CARO, 2020.

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(ii) As per clause (vii) (b) of Paragraph 3 of CARO,2020, the auditor is required to report where statutory dues have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.

In the given situation, the survey team pointed out certain lapses regarding non-deduction of TDS and demand raised by DCIT(TDS). TDS dues are in the nature of statutory dues and the company has filed appeal against order of DCIT (TDS) raising a demand of ₹ 25 lacs with JCIT (Appeals). Therefore, these are in the nature of disputed statutory dues. Thus, it should be reported in accordance with Clause (vii) (b) of Paragraph 3 of CARO, 2020.

14. Drafting of Opinion Paragraph and basis thereof along with disclosure of Note XX:

INDEPENDENT AUDITOR'S REPORT

To the Members of Delhi Branch Office of Fancy Limited

Report on the Audit of the Standalone Financial Statements

Opinion

We have audited the standalone financial statements of Delhi Branch Office of Fancy Limited ("the Company"), which comprise the balance sheet as at March 31, 2024, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, give a true and fair view, in conformity with the accounting principles generally accepted in India, of the state of affairs of the Delhi Branch Office of the Company as at March 31, 2024 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the ICAI's Code of Ethics and the provisions of the Companies Act, 2013, and we have fulfilled our other ethical

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responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note XX regarding Delhi Branch Office management's intention to close the operations of the Branch Office subject to regulatory approvals. Accordingly, the financial statements have been prepared on the basis that the Delhi Branch Office does not continue to be a going concern and provisions have been made in the books of account for the losses arising or likely to arise on account of closure of operations including the losses on the realizability of current assets.

Our opinion is not modified in respect of this matter.

15. ***Reporting under Paragraph 3 of CARO, 2020: Clause (viii) of Paragraph 3 of CARO, 2020 requires the auditor to report whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income-tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year.***

In addition, Clause (xviii) of Paragraph 3 of CARO, 2020 requires the auditor to report whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors.

In the given situation, during audit an order dated 01.05.2023 under section 148 of the Income-tax Act, 1961 was noticed wherein tax of ₹ 50 lakh were demanded owing to undisclosed cash sales of 150 lakh for the financial year 2020-21 which was accepted by the company and the applicable tax was paid by the company during the year 2023-24. The company has not recorded such undisclosed income in their books of account during the year 2023-24. The auditor would be required to report as per Clause (viii) of Paragraph 3 of CARO, 2020.

Further CA T, the auditor of SDA Limited resigned due to non-recording of such undisclosed income in their books of account. The auditor would be required to report the same in CARO, 2020 as per Clause (xviii) of Paragraph 3 of CARO, 2020.

Hence, the auditor would be required to report as per Clause (viii) and Clause (xviii) of Paragraph 3 of CARO 2020 for the year 2023-24.

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16. *A liability is a present obligation of the entity to transfer an economic resource as a result of past events. Instead of fulfilling an obligation to transfer an economic resource to the party that has a right to receive that resource, entities sometimes decide to, for example: -*

(a) settle the obligation by negotiating a release from the obligation;

(b) transfer the obligation to a third party; or

(c) replace that obligation to transfer an economic resource with another obligation by entering into a new transaction.

In the above situations, an entity has the obligation to transfer an economic resource until it has settled, transferred or replaced that obligation.

In the given situation, the company has written back liabilities due to creditors unilaterally. The company has not settled the obligation by negotiating a release from the obligation from respective creditors. Such an accounting treatment by management is questionable and against the conceptual framework for financial reporting under Ind AS.

CA Srishti wanted to send external confirmations in accordance with SA 505, "External Confirmations" but management informed her that sending such requests may be used by creditors as proof of existence of liability. In fact, she should display professional skepticism and be alert to the possibility of misstatements in financial statements, if restrained by management from obtaining external confirmations. The reasons advanced by management do not appear to be valid and reasonable. In accordance with SA 505, she should reassess risks and perform alternative audit procedures to mitigate such risks. Besides, she should consider implications of same for her audit opinion.

Further, SA 705, "Modifications to the Opinion in the Independent Auditor's Report" requires that the auditor shall modify the opinion in the auditor's report when: -

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

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

SA 705 also states that misstatements in financial statements arise when selected accounting policies are not in accordance with an applicable financial reporting framework. It also states that examples of an inability to obtain sufficient appropriate audit evidence arise from a limitation on the scope of audit imposed by management when management prevents the auditor from requesting external confirmation of specific account balances. Therefore, she needs to issue a modified opinion.

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Keeping in view above, her contemplation of including above matters under "Key audit matters" is not proper and is not in accordance with SA 701," Communicating Key Audit Matters in the Independent Auditor's Report". It states that the auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion in accordance with SA 705 as a result of the matter. Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705.

17. *Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists:*

As per SA 720, "The Auditor's Responsibility in Relation to Other Information", descriptions of trends in market prices of key commodities or raw materials is an example of amounts or other Items that may be included in the other information.

The auditor's discussion with management about a material inconsistency (or other information that appears to be materially misstated) may include requesting management to provide support for the basis of management's statements in the other information. Based on management's further information or explanations, the auditor may be satisfied that the other information is not materially misstated. For example, management explanations may indicate reasonable and sufficient grounds for valid differences of judgment.

Auditor's duties with regard to reporting in the given case are given hereunder:

As per SA 720, "The Auditor's Responsibility in Relation to Other Information", if the auditor concludes that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management:

(i) Agrees to make the correction, the auditor shall determine that the correction has been made; or

(ii) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

Contention of the partner of the firm that auditors are not concerned with such disclosures made by the management in its annual report, is incorrect.

18. *As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor is required to obtain an understanding and need to evaluate the impact of other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for*

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example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements.

The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities

As per section 143(3)(j) read with Rule 11(a), the auditor is required to report whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement.

As per SA 570, "Going Concern", if the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

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

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

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall (a) Express a Qualified opinion or Adverse opinion, as appropriate, in accordance with SA 705; and (b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

In the current scenario, Nandini Ltd. has received a show cause notice from the National Green Tribunal of an amount which is more than the net profit and the

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turnover of the company for the year. In the event of an unfavourable order for Nandini Ltd., there will be an impact on Nandini Ltd.'s ability to continue as a going concern. As a result, appropriate disclosure should be provided by management for such events, which cast significant doubt on the entity's ability to continue as a going concern. As no appropriate disclosure has been provided by Nandini Ltd. for such show cause notice, Vasu & Co. should report this matter in their audit report under "Going Concern Para" as per SA 570 and under clause (j) of section 143(3) of the Companies Act, 2013. Also, the auditor is required to issue an Adverse opinion as per SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

19. *Observation 1 - The management had disclosed in the financials that, during the year, one of the warehouses of the Company was affected due to a major flood. As a result of the same, the Company had incurred some losses. But the management was of the view that it was not material. As per SA 706, "Emphasis of Matter Paragraph & Other Matter Paragraph in the Independent Auditor's Report", an Emphasis of Matter Paragraph refers to matter appropriately disclosed in the financials, that in the auditor's judgement is of such importance that it is fundamental to users' understanding of the financials. Hence, in this case, the auditor shall report about the consequences of the flood which affected the company's warehouse under Emphasis of Matter Paragraph.*

Observation 2 - Due to flood, few records maintained by the Company with respect to a particular transaction were destroyed and no duplicate records were maintained by the Company. However, those details were not pervasive, but material. As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", where the auditor is unable to obtain sufficient and appropriate audit evidence and where such matter is material but not pervasive, the auditor shall issue a Qualified opinion.

Thus, in the given situation, on account of flood few records pertaining to particular transactions were completely destroyed and in the absence of duplicate records, the auditor was unable to obtain sufficient and appropriate audit evidence and those details were material but not pervasive. Therefore, in accordance with SA 705, the auditor is required to issue Qualified opinion.

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CHAPTER 8

SPECIALISED AREAS



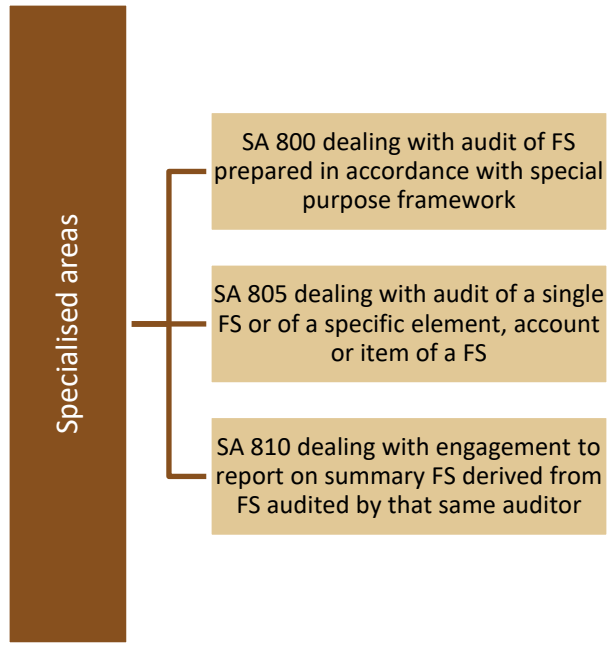
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Know about special considerations applicable in respect of the audit of financial statements prepared in accordance with the special purpose *framework* as per SA 800.
- Understand the meaning of special purpose framework.
- Know about special considerations applicable in acceptance, planning and performance and forming an opinion and reporting in such types of engagements.
- Gain knowledge about special considerations applicable to an audit of a single financial statement or of a specific element, account or item of a financial statement in accordance with SA 805.
- Understand the meaning of a single financial statement and elements of a financial statement.
- Know about special considerations applicable in acceptance, planning and performance and forming an opinion and reporting in such types of engagements in accordance with requirements of SA 805.
- Understand the responsibilities of an auditor when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by the same auditor in accordance with SA 810.
- Know about special considerations applicable in acceptance, planning and performance and forming an opinion and reporting in such type of engagements in accordance with requirements of SA 810.
- Understand elements of audit report issued on summary financial statements in accordance with SA 810.

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CHAPTER OVERVIEW



CA Julie has joined an audit firm based in Mumbai. On her very first day in office, she was handed over an assignment pertaining to the audit of a client whose financial statements had been prepared in pursuance to the financial reporting provisions of a contract. The said client had entered into a contract with various entities stipulating payments to be made to these entities on the basis of certain parameters in lieu of services rendered by these entities to the auditee client.

The contract, inter alia, contained a provision that financial statements shall be specifically prepared considering the requirements of the contract. She was in a dilemma. Do Standards on Auditing apply to such types of engagements? Are there any special considerations to be borne in mind by the auditor before accepting such an engagement? Most importantly, she was worried about reporting aspects. The report in such a case was not going to be issued under the Companies Act 2013. What factors would come into play in such a case? She was also turning sceptical towards the possible use of the report.

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Julie wondered if there were any authoritative guidelines on this matter. Frustrated that she had barely passed the auditing paper in her CA final exams, she turned to the ICAI website for help. She discovered that SA 800 provided guidance for her situation. To gain better clarity, she also watched recorded webinars on the topic.

Through these resources, Julie learned that the SA 800-899 series deals with specialised areas. SA 800 covers special considerations in the audit of financial statements prepared in accordance with a special purpose framework, while SA 805 addresses special considerations to an audit of a single financial statement or of a specific element, account or item of a financial statement. Although she was familiar with the concept of elements of financial statements, the term "single financial statement" was new to her.

She found the whole topic of specialised areas quite interesting and delved deeper into the requirements of SA 810. She was astonished at the detailing made in SA 810 regarding summary financial statements, the nature of procedures, forming opinions and reporting considerations. All this was like a breath of fresh air. Julie was excited about applying these learnings in practice and felt more confident about her assignment.

1. INTRODUCTION

Special considerations apply in respect of the audit of financial statements prepared in accordance with the special purpose framework. Similarly, special considerations apply to an audit of a single financial statement or of a specific element, account or item of a financial statement.

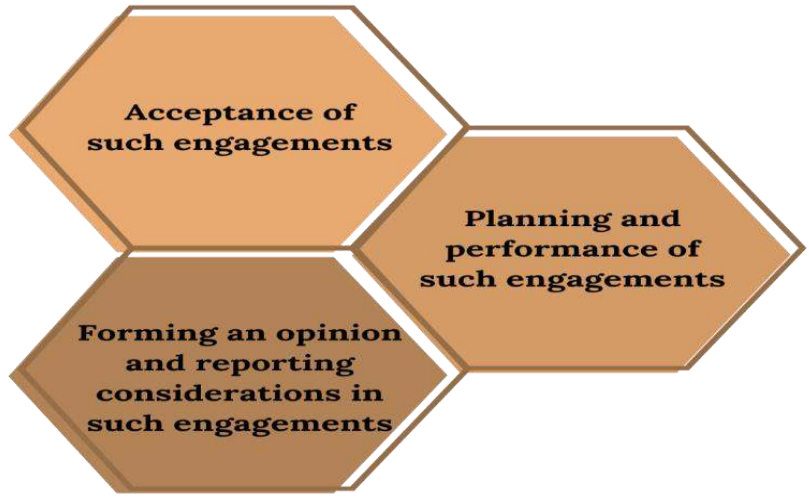
Specific responsibilities are cast upon an auditor in case of undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor.

There are three separate SAs for the above specialised areas as under: -

• SA 800 deals with special considerations applicable in respect of the audit of financial statements prepared in accordance with the special purpose framework.
• SA 805 deals with special considerations applicable to an audit of a single financial statement or of a specific element, account or item of a financial statement.
• SA 810 deals with responsibilities of an auditor when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor.

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All the aforesaid discussed Standards on auditing broadly deal with following areas: -



2. SA 800, SPECIAL CONSIDERATIONS - AUDITS OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH SPECIAL PURPOSE FRAMEWORKS (REVISED)

As discussed above, SA 800 deals with special considerations applicable in respect of audit of financial statements prepared in accordance with special purpose framework.

SA 800 addresses special considerations that are relevant to: -	
(a)	The acceptance of the engagement
(b)	The planning and performance of that engagement and
(c)	***Forming an opinion and reporting on the financial statements.***

2.1 What is Special Purpose framework?

SA 800 defines special purpose framework as a financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The requirements of the applicable financial reporting framework determine the form and content of the financial statements and what constitutes a complete set of financial statements.

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Examples of Special purpose frameworks are: -

- ***The cash basis of accounting and also cash flow information that an entity may be required to prepare for creditors.***
- The financial reporting provisions established by a regulator to meet the requirements of that regulator.
- The financial reporting provisions of a contract, such as a bond indenture, a loan agreement, or a project grant.

The special purpose framework is to be distinguished from the general purpose framework. A financial reporting framework designed to meet the common financial information needs of a wide range of users is known as the "General purpose framework", whereas a financial reporting framework designed to meet the financial information needs of specific users is known as the "Special purpose framework."

Reference to "financial statements" in this SA means "a complete set of special purpose financial statements" including the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The requirements of the applicable financial reporting framework determine the form and content of the financial statements and what constitutes a complete set of financial statements.

2.2 Considerations When Accepting Such Engagement

In the case of special purpose financial statements, the financial information needs of the intended users are a key factor in determining the acceptability of the financial reporting framework applied in the preparation of the financial statements. The applicable financial reporting framework may encompass the financial reporting standards established by an organisation that is authorised or recognised to promulgate standards for special purpose financial statements.

In that case, those standards will be presumed acceptable for that purpose if the organisation follows an established and transparent process involving deliberation and consideration of the views of relevant stakeholders. Some laws or regulations may prescribe the financial reporting framework to be used by management in the preparation of special purpose financial statements for a certain type of entity. For example, a regulator may establish financial reporting provisions to meet the requirements of that regulator. In the absence of indications to the contrary, such a financial reporting framework is presumed acceptable for special purpose financial statements prepared by such an entity.

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Where the financial reporting standards referred to above are supplemented by legislative or regulatory requirements, SA 210 requires the auditor to determine whether any conflicts between the financial reporting standards and the additional requirements exist and prescribes actions to be taken by the auditor if such conflicts exist.

The applicable financial reporting framework may encompass the financial reporting provisions of a contract or sources other than those described in the preceding paras. In that case, the acceptability of the financial reporting framework in the circumstances of the engagement is determined by considering whether the framework exhibits attributes normally exhibited by acceptable financial reporting frameworks in accordance with the requirements of SA 210.

In the case of a special purpose framework, the relative importance to a particular engagement of each of the attributes normally exhibited by acceptable financial reporting frameworks is a matter of professional judgment.

For example, for purposes of establishing the value of net assets of an entity at the date of its sale, the vendor and the purchaser may have agreed that very prudent estimates of allowances for uncollectible accounts receivable are appropriate for their needs, even though such financial information is not neutral when compared with financial information prepared in accordance with a general purpose framework.

2.3 Considerations When Planning and Performing Such Audit

SA 200 requires the auditor to comply with:
(a) relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements, and
(b) all SAs relevant to the audit.

It also requires the auditor to comply with each requirement of an SA unless, in the circumstances of the audit, the entire SA is not relevant, or the requirement is not relevant because it is conditional and the condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an SA by performing alternative audit procedures to achieve the aim of that requirement.

Application of some of the requirements of the SAs in an audit of special purpose financial statements may require special consideration by the auditor. **For example**, in SA 320, judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. In the case of an audit of special

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purpose financial statements, however, those judgments are based on a consideration of the financial information needs of the intended users.

SA 315 requires the auditor to obtain an understanding of the entity's selection and application of accounting policies. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements. An interpretation is significant when adoption of another reasonable interpretation would have produced a material difference in the information presented in the financial statements.

In the case of special purpose financial statements, such as those prepared in accordance with the requirements of a contract, management may agree with the intended users on a threshold below which misstatements identified during the audit will not be corrected or otherwise adjusted. The existence of such a threshold does not relieve the auditor from the requirement to determine materiality in accordance with SA 320 for purposes of planning and performing the audit of the special purpose financial statements.

SA 260 (Revised) requires the auditor to determine the appropriate person(s) within the entity's governance structure with whom to communicate. SA 260 (Revised) notes that, in some cases, all of those charged governance are involved in managing the entity, and the application of the communication requirements is modified to recognize this position. When a complete set of general purpose financial statements is also prepared by the entity, those person(s) responsible for the oversight of the preparation of the special purpose financial statements may not be the same as those charged with governance responsible for the oversight of the preparation of those general purpose financial statements.

Forming an Opinion and Reporting Considerations in such an Audit: When forming an opinion and reporting on special purpose financial statements, the auditor shall apply the requirements in Revised SA 700.

2.4 Description of the Applicable Financial Reporting Framework

Revised SA 700 requires the auditor to evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

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SA 700(Revised) deals with the form and content of the auditor's report, ***including the specific ordering of certain elements***. In the case of an auditor's report on special purpose financial statements:

(a) The auditor's report shall also describe the purpose for which the financial statements are prepared and, if necessary, the intended users, or refer to a note in the special purpose financial statements that contain that information; and

(b) If management has a choice of financial reporting frameworks in the preparation of such financial statements, the explanation of management's responsibility for the financial statements shall also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

(c) When key audit matters are communicated in the auditor's report on special purpose financial statements, SA 701 applies in its entirety.

(d) SA 720(Revised) deals with the auditor's responsibilities relating to other information. In the context of this SA, reports containing or accompanying the special purpose financial statements – the purpose of which is to provide owners (or similar stakeholders) with information on matters presented in special purpose financial statements – are considered to be annual reports for the purposes of SA 720(Revised). In the case of financial statements prepared using a special purpose framework, the term "similar stakeholders" includes the specific users whose financial information needs are met by the design of the special purpose framework used to prepare the special purpose financial statements. When the auditor determines that the entity plans to issue such a report, the requirements of SA 720(Revised) apply to the audit of the special purpose financial statements.

(e) The auditor may deem it appropriate to refer, in an Other Matter paragraph in the auditor's report on the special purpose financial statements, to the auditor's report on the complete set of general purpose financial statements or to matter(s) reported therein as per SA 706 (Revised). For example, the auditor may consider it appropriate to refer in the auditor's report on the special purpose financial statements to a Material Uncertainty Related to Going Concern section included in the auditor's report on the complete set of general purpose financial statements.

2.5 Alerting Readers that the Financial Statements Are Prepared in Accordance with a Special Purpose Framework

The special purpose financial statements may be used for purposes other than those for which they were intended. For example, a regulator may require certain entities to place the special purpose

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financial statements on public records. ***To avoid misunderstandings, the auditor alerts users of the auditor's report by including an Emphasis of Matter paragraph explaining that the financial statements are prepared in accordance with a special purpose framework and, therefore, may not be suitable for another purpose. SA 706(Revised) requires this paragraph to be included within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter".***

2.6 Restriction on Distribution or Use

In addition to the alert required as discussed above, the auditor may consider it appropriate to indicate that the auditor's report is intended solely for the specific users. Depending on the law or regulation applicable, this may be achieved by restricting the distribution or use of the auditor's report. In these circumstances, the paragraph alerting the readers may be expanded to include these other matters, and the heading modified accordingly.

Example of Emphasis of Matter - Basis of Accounting and Restriction on Distribution and Use

We draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the Company in complying with the financial reporting provisions of the contract referred to above. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for the Company and DEF Company Limited and should not be distributed to or used by parties other than the Company or DEF Company Limited. Our opinion is not modified in respect of this matter.

TEST YOUR UNDERSTANDING 1

CA Lalita is auditor of a company. She is also offered professional work of audit of financial statements prepared specifically for meeting requirements of a loan agreement for the same period. She chooses to accept work and has made up her mind to disclose this fact in "Emphasis of Matter Paragraph" in audit report to be issued by her for this specific engagement. Is her approach proper?

TEST YOUR UNDERSTANDING 2

CA Lakshmi has prepared a draft audit report for financial statements of X Ltd. prepared in accordance with financial reporting provisions of a contract with Y Ltd. She has drafted an unmodified opinion to be given in audit report. Besides, she has also drawn attention in draft audit report to Note "A "to the financial statements which describes the basis of accounting (under the heading "Basis of accounting"). How she should ensure that report would not be misused? Draft a suitable para to be included in the report for this purpose.

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3. SA 805-SPECIAL CONSIDERATIONS—AUDITS OF SINGLE FINANCIAL STATEMENTS AND SPECIFIC ELEMENTS, ACCOUNTS OR ITEMS OF A FINANCIAL STATEMENT (REVISED)

The Standards on Auditing (SAs) in the 100-700 series apply to an audit of financial statements and are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. This SA deals with special considerations in the application of those SAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, ***SA 800(Revised)*** *also applies to the audit.*

SA 805 does not apply to the report of a component auditor, issued as a result of work performed on the financial information of a component at the request of a principal auditor for purposes of an audit of consolidated financial statements.

The objective of the auditor, when applying SAs in an audit of a single financial statement or of a specific element, account or item of a financial statement, is to address appropriately the special considerations that are relevant to:

(a) The acceptance of the engagement;

(b) The planning and performance of that engagement; and

(c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement.

3.1 What is a Single Financial Statement?

A single financial statement is to be distinguished from a complete set of financial statements. **For example,** a cash flow statement is a single financial statement.

3.2 What is the Element of a Financial Statement?

"Element of a financial statement" or "element" means an *"element, account or item of a financial statement." For example, trade receivables or cash and bank balances*

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A single financial statement or a specific element of a financial statement includes the related notes ordinarily comprising a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

3.3 Considerations When Accepting Such Engagement

3.3.1 Application of SAs

SA 200 requires the auditor to comply with all SAs relevant to the audit. In the case of an audit of a single financial statement or of a specific element of a financial statement, this requirement applies irrespective of whether the auditor is also engaged to audit the entity's complete set of financial statements. If the auditor is not also engaged to audit the entity's complete set of financial statements, the auditor shall determine whether the audit of a single financial statement or of a specific element of those financial statements in accordance with SAs is practicable.

SA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining to independence relating to financial statement audit engagements, and (b) all SAs relevant to the audit. It also requires the auditor to comply with each requirement of an SA unless, in the circumstances of the audit, the entire SA is not relevant or the requirement is not relevant because it is conditional and the condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an SA by performing alternative audit procedures to achieve the aim of that requirement.

Compliance with the requirements of SAs relevant to the audit of a single financial statement or of a specific element of a financial statement may not be practicable when the auditor is not also engaged to audit the entity's complete set of financial statements. In such cases, the auditor often does not have the same understanding of the entity and its environment, including its internal control, as an auditor who also audits the entity's complete set of financial statements. The auditor also does not have audit evidence about the general quality of the accounting records or other accounting information that would be acquired in an audit of the entity's complete set of financial statements. Accordingly, the auditor may need further evidence to corroborate audit evidence acquired from the accounting records.

In the case of an audit of a specific element of a financial statement, certain SAs require audit work that may be disproportionate to the element being audited. For example, although the requirements of SA 570 are likely to be relevant in the circumstances of an audit of a schedule of accounts receivable, complying with those requirements may not be practicable because of the audit effort required. If the auditor concludes that an audit of a single financial statement or of a specific element

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of a financial statement in accordance with SAs may not be practicable, the auditor may discuss with management whether another type of engagement might be more practicable.

3.3.2 Acceptability of the Financial Reporting Framework

SA 210 requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements. In the case of an audit of a single financial statement or of a specific element of a financial statement, this shall include whether application of the financial reporting framework will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element, and the effect of material transactions and events on the information conveyed in the financial statement or the element.

A single financial statement or a specific element of a financial statement may be prepared in accordance with an applicable financial reporting framework that is based on a financial reporting framework established by an authorised or recognised standards setting organisation for the preparation of a complete set of financial statements [e.g., Financial Reporting Framework]. If this is the case, determination of the acceptability of the applicable framework may involve considering whether that framework includes all the requirements of the framework on which it is based that are relevant to the presentation of a single financial statement or of a specific element of a financial statement that provides adequate disclosures.

3.4 Considerations When Planning and Performing the Audit

In planning and performing the audit of a single financial statement or of a specific element of a financial statement, the auditor shall adapt all SAs relevant to the audit as necessary in the circumstances of the engagement. ***The relevance of each of the SAs requires careful consideration. Even when only a specific element of a financial statement is the subject of the audit, SAs such as SA 240, SA 550 and SA 570(Revised) are, in principle, relevant. This is because the element could be misstated as a result of fraud, the effect of related party transactions, or the incorrect application of the going concern basis of accounting under the applicable financial reporting framework.***

SA 260(Revised) requires the auditor to determine the appropriate person(s) within the entity's governance structure with whom to communicate. SA 260(Revised) notes that, in some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognise this position. When complete set of financial statements is also prepared by the entity, those person(s) responsible for the oversight of the preparation of the single financial statement or the

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element may not be the same as those charged with governance responsible for the oversight of the preparation of the complete set of financial statements.

When auditing a single financial statement or a specific element of a financial statement in conjunction with the audit of the entity's complete set of financial statements, the auditor may be able to use audit evidence obtained as part of the audit of the entity's complete set of financial statements in the audit of the financial statement or the element. SAs, however, require the auditor to plan and perform the audit of the financial statement or element to obtain sufficient appropriate audit evidence on which to base the opinion on the financial statement or on the element.

The individual financial statements that comprise a complete set of financial statements, and many of the elements of those financial statements, including their related notes, are interrelated. Accordingly, when auditing a single financial statement or a specific element of a financial statement, the auditor may not be able to consider the financial statement or the element in isolation. Consequently, the auditor may need to perform procedures in relation to the interrelated items to meet the objective of the audit.

Furthermore, the materiality determined for a single financial statement or for a specific element of a financial statement may be lower than the materiality determined for the entity's complete set of financial statements; this will affect the nature, timing and extent of the audit procedures and the evaluation of uncorrected misstatements.

3.5 Form of Opinion

SA 210 requires that the agreed terms of the audit engagement include the expected form of any reports to be issued by the auditor. In the case of an audit of a single financial statement or of a specific element of a financial statement, the auditor shall consider whether the expected form of opinion is appropriate in the circumstances.

The form of opinion to be expressed by the auditor depends on the applicable financial reporting framework and any applicable laws or regulations. In accordance with Revised SA 700:

(a) When expressing an unmodified opinion on a complete set of financial statements prepared in accordance with a fair presentation framework, the auditor's opinion, unless otherwise required by law or regulation, uses one of the following phrases: (i) the financial statements present fairly, in all material respects, in accordance with the applicable financial reporting framework or (ii) the financial statements give a true and fair view in accordance with the applicable financial reporting framework and

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(b) When expressing an unmodified opinion on a complete set of financial statements prepared in accordance with a compliance framework, the auditor's opinion states that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In the case of *a single financial statement or of a specific element of a financial statement*, the applicable financial reporting framework may not explicitly address the presentation of the financial statement or of the specific element of the financial statement. This may be the case when the applicable financial reporting framework is based on a financial reporting framework established by an authorised or recognised standards setting organisation for the preparation of a complete set of financial statements The auditor therefore considers whether the expected form of opinion is appropriate in the light of the applicable financial reporting framework.

Factors that may affect the auditor's consideration as to whether to use the phrases "presents fairly, in all material respects", or "gives a true and fair view" in the auditor's opinion include:	
• Whether the applicable financial reporting framework is explicitly or implicitly restricted to the preparation of a complete set of financial statements.	
• Whether the single financial statement or the specific element of a financial statement will:	
♦ Comply fully with each of those requirements of the framework relevant to the particular financial statement or the particular element, and the presentation of the financial statement or the specific element of a financial statement include the ***related disclosures.***	♦ If necessary to achieve fair presentation, provide disclosures beyond those specifically required by the framework or, in exceptional circumstances, depart from a requirement of the framework.

The auditor's decision as to the expected form of opinion is a matter of professional judgment. It may be affected by whether use of the phrases "presents fairly, in all material respects", or "gives a true and fair view" in the auditor's opinion on a single financial statement or on a specific element of a financial statement prepared in accordance with a fair presentation framework is generally accepted in the particular jurisdiction.

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3.6 Forming an Opinion and Reporting Considerations

When forming an opinion and reporting on a single financial statement or on a specific element of a financial statement, the auditor shall apply the requirements in Revised SA 700, and, when applicable, SA 800(Revised) adapted as necessary in the circumstances of the engagement. In doing so, the auditor is also required to apply the reporting requirements in other SAs, adapted as necessary in the circumstances of the engagement, and may find the considerations addressed in SA 700(Revised).

Revised SA 700 requires the auditor, in forming an opinion, to evaluate whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements. In the case of a single financial statement or of a specific element of a financial statement, it is important that the financial statement or the element, including the related notes, in view of the requirements of the applicable financial reporting framework, provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element, and the effect of material transactions and events on the information conveyed in the financial statement or the element.

Going Concern: Depending on the applicable financial reporting framework used in the preparation of the single financial statement or the specific element of a financial statement, the description in the auditor's report of management's responsibilities relating to going concern may need to be adapted, as necessary. The description in the auditor's report of the auditor's responsibilities may also need to be adapted as necessary depending on how SA 570(Revised) applies in the circumstances of the engagement.

Key Audit Matters: SA 700(Revised) requires the auditor to communicate key audit matters in accordance with SA 701 for audits of complete sets of general purpose financial statements of listed entities.

Other Information: SA 720(Revised) deals with the auditor's responsibilities relating to other information. In the context of this SA, reports containing or accompanying the single financial statement or specific element of a financial statement – the purpose of which is to provide owners (or similar stakeholders) with information on matters presented in the single financial statement or the specific element of a financial statement – are considered to be annual reports for the purposes of SA 720(Revised). When the auditor determines that the entity

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plans to issue such a report, the requirements of SA 720(Revised) apply to the audit of the single financial statement or the element.

Signature of the Auditor: The auditor's report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the auditor's report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the auditor's reports signed by them.

This SA requires the auditor to consider the implications, if any, of certain matters included in the auditor's report on the complete set of financial statements for the audit of the single financial statement or the specific element of a financial statement and for the auditor's report thereon. Considering whether a matter included in the auditor's report on the complete set of financial statements is relevant in the context of an engagement to report on a single financial statement or a specific element of a financial statement involves professional judgment.

Factors that may be relevant in considering those implications include:

- ***The nature of the matter(s) being described in the auditor's report on the complete set of financial statements and the extent to which it relates to what is included in the single financial statement or a specific element of a financial statement.***
- ***The pervasiveness of the matter(s) described in the auditor's report on the complete set of financial statements.***
- ***The nature and extent of the differences between the applicable financial reporting frameworks.***
- ***The extent of the difference between the period(s) covered by the complete set of the financial statements compared to the period(s) or dates of the single financial statement or the element of a financial statement.***
- ***The time elapsed since the date of the auditor's report on the complete set of the financial statements.***

For example, in the case when there is a qualification of the auditor's opinion in relation to accounts receivable in the auditor's report on the complete set of financial statements, and the single financial statement includes accounts receivable, or the specific element of a financial statement relates to accounts receivable, it is likely that there would be implications

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for the audit. On the other hand, if the qualification of the auditor's opinion on the complete set of financial statements relates to classification of long-term debt, then it is less likely that there would be implications for an audit of the single financial statement that is the Statement of Profit and Loss, or if the specific element of the financial statement relates to accounts receivable.

Inclusion of a reference to the auditor's report on the complete set of financial statements: Even when certain matters included in the auditor's report on the complete set of financial statements do not have implications for the audit of, or for the auditor's report on, the single financial statement or the specific element of a financial statement, the auditor may deem it appropriate to refer to the matter(s) in an Other Matter paragraph in an auditor's report on the single financial statement or on the specific element of a financial statement as per SA 706(Revised).

For example, the auditor may consider it appropriate to refer in the auditor's report on the single financial statement or a specific element of the financial statement to a Material Uncertainty Related to Going Concern section included in the auditor's report on the complete set of financial statements.

If the auditor undertakes an engagement to report on a single financial statement or on a specific element of a financial statement in conjunction with an engagement to audit the entity's complete set of financial statements, the auditor shall express a separate opinion for each engagement.

The audited single financial statement or the audited specific element of a financial statement may be published together with the entity's audited complete set of financial statements. If the auditor concludes that the presentation of the single financial statement or of the specific element of a financial statement does not differentiate it sufficiently from the complete set of financial statements, the auditor shall ask management to rectify the situation. The auditor shall also differentiate the opinion on the single financial statement or on the specific element of a financial statement from the opinion on the complete set of financial statements. The auditor shall not issue the auditor's report containing the opinion on the single financial statement or on the specific element of a financial statement until satisfied with the differentiation.

Considering the Implications of Certain Matters Included in the Auditor's Report on the Entity's Complete Set of Financial Statements for the Audit of the Single Financial Statement or the Specific Element of a Financial Statement and for the Auditor's Report Thereon

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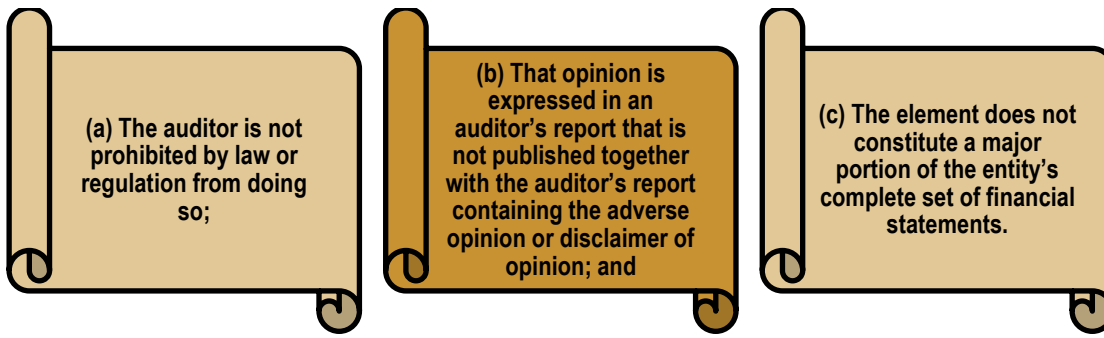
If the auditor's report on an entity's complete set of financial statements includes:
(a) A modified opinion in accordance with SA 705(Revised);
(b) An Emphasis of Matter paragraph or an Other Matter paragraph in accordance with SA 706(Revised);
(c) A Material Uncertainty Related to Going Concern section in accordance with SA 570(Revised); or
(d) A statement that describes an uncorrected material misstatement of the other information in accordance with SA 720(Revised).

the auditor shall consider the implications, if any, that these matters, may have for the audit of the single financial statement or of the specific element of a financial statement and for the auditor's report thereon.

Adverse Opinion or Disclaimer of Opinion in the Auditor's Report on the Entity's Complete Set of Financial Statements:

If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole, Revised SA 705 does not permit the auditor to include in the same auditor's report an unmodified opinion on a single financial statement that forms part of those financial statements or on a specific element of those financial statements. This is because such an unmodified opinion would contradict the adverse opinion or disclaimer of opinion on the entity's complete set of financial statements as a whole.

If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole but, in the context of a separate audit of a specific element that is included in those financial statements, the auditor nevertheless considers it appropriate to express an unmodified opinion on that element, the auditor shall only do so if:



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The auditor shall not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole. This is the case even if the auditor's report on the single financial statement is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion. This is because a single financial statement is deemed to constitute a major portion of those financial statements.

In the auditor's report on an entity's complete set of financial statements, the expression of a disclaimer of opinion regarding the results of operations and cash flows, where relevant, and an unmodified opinion regarding the state of affairs is permitted since the disclaimer of opinion is being issued in respect of the results of operations and cash flows only and not in respect of the financial statements as a whole.

SA 800 and 805 do not override the requirements of the other SAs; nor do they purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

Examples of Specific Elements, Accounts or Items of a Financial Statement are	● Accounts receivable, allowance for doubtful accounts receivable, inventory, the liability for accrued benefits of a private pension plan, the recorded value of identified intangible assets, or the liability for "incurred but not reported" claims in an insurance portfolio, including related notes.
	● A schedule of externally managed assets and income of a private pension plan, including related notes.
	● A schedule of net tangible assets, including related notes.
	● A schedule of disbursements in relation to a lease property, including explanatory notes.
	A schedule of profit participation or employee bonuses, including explanatory notes.

TEST YOUR UNDERSTANDING 3

CA M. Surya is auditor for financial statements of an entity prepared in accordance with financial reporting provisions of a contract. He is also offered an audit of trade receivables appearing in above financial statements. Can he accept such an engagement? Discuss brief outline of his audit approach in such a situation.

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TEST YOUR UNDERSTANDING 4

CA G is offered appointment for audit of trade payables of financial statements of a company. However, financial statements prepared under Companies Act, 2013 are audited by CA Jignesh. Discuss why it would be practically difficult for CA G to perform such an audit.



4. SA 810 - ENGAGEMENTS TO REPORT ON SUMMARY FINANCIAL STATEMENTS (REVISED)

SA 810 deals with the auditor's responsibilities when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor.

4.1 What do Summary Financial Statements Reflect?

Summary financial statements reflect historical financial information that is derived from financial statements but that contains less detail than the financial statements while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time. ***Different laws and regulations may use different terminology to describe such historical financial information.***

4.2 Engagement Acceptance

The auditor shall, ordinarily, accept an engagement to report on summary financial statements in accordance with this SA only when the auditor has been engaged to conduct an audit in accordance with SAs of the financial statements from which the summary financial statements are derived. If the auditor has not also audited the financial statements from which the summary financial statements are derived, the auditor shall not have the necessary knowledge to discharge his responsibilities in relation to the summary financial statements in accordance with this SA.

Herein lies the rationale behind the requirement that engagement to report on summary financial statements shall, ordinarily, be accepted when the auditor has been engaged to conduct an audit of financial statements from which summary financial statements are derived.

4.2.1 Before accepting an engagement to report on summary financial statements, the auditor shall:

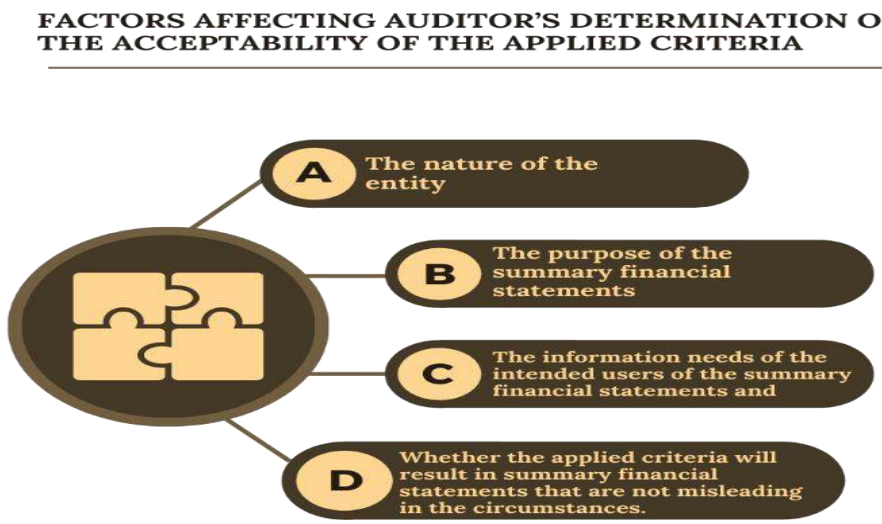
(a) Determine whether the applied criteria are acceptable.

Applied criteria refer to the criteria applied by management in the preparation of the summary

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financial statements. ***The preparation of summary financial statements requires management to determine the information that needs to be reflected in the summary financial statements so that they are consistent, in all material respects, with or represent a fair summary of the audited financial statements. Because summary financial statements by their nature contain aggregated information and limited disclosure, there is an increased risk that they may not contain the information necessary so as not to be misleading in the circumstances. This risk increases when established criteria for the preparation of summary financial statements do not exist.***

Factors affecting the auditor's determination of the acceptability of the applied criteria:
➢ The nature of the entity ➢ The purpose of the summary financial statements ➢ The information needs of the intended users of the summary financial statements and ➢ Whether the applied criteria will result in summary financial statements that are not misleading in the circumstances.



The criteria for the preparation of summary financial statements may be established by an authorised or recognised standards setting organisation or by law or regulation. Similar to the case of financial statements, as explained in SA 210, in many such cases, the auditor may presume that such criteria are acceptable. Where established criteria for the preparation of summary financial statements do

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not exist, criteria may be developed by management, for example, based on practice in a particular industry.

If the auditor concludes that the applied criteria are unacceptable or is unable to obtain the agreement of management as discussed above, the auditor shall not accept the engagement to report on the summary financial statements, unless required by law or regulation to do so. An engagement conducted in accordance with such law or regulation does not comply with this SA. Accordingly, the auditor's report on the summary financial statements shall not indicate that the engagement was conducted in accordance with this SA. The auditor shall include appropriate reference to this fact in the terms of the engagement. The auditor shall also determine the effect that this may have on the engagement to audit the financial statements from which the summary financial statements are derived.

Adequate disclosure of the summarised nature of the summary financial statements and the identity of the audited financial statements, may, for example, be provided by a title such as "*Summary financial statements prepared from the audited financial statements for the year ended March 31, 20XX".*

(b)	**Obtain the agreement of management that it acknowledges and understands its responsibility:**

i. For the preparation of the summary financial statements in accordance with the applied criteria.

ii. To make the audited financial statements available to the intended users of the summary financial statements without undue difficulty (or, if law or regulation provides that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements, to describe that law or regulation in the summary financial statements).

The auditor's evaluation whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty is affected by factors such as whether:
• The summary financial statements describe clearly from whom or where the audited financial statements are available;
• The audited financial statements are on public record; or
• Management has established a process by which the intended users of the summary financial statements can obtain ready access to the audited financial statements.

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iii. To include the auditor's report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them.

(c)	**Agree with management on the form of opinion to be expressed on the summary financial statements.**

4.3 Nature of Procedures to be Performed by Auditor

The auditor shall perform the following procedures, and any other procedures that the auditor may consider necessary, as the basis for the auditor's opinion on the summary financial statements:	
(a)	**Evaluate whether the summary financial statements adequately disclose their summarised nature and identify the audited financial statements.**
(b)	**When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:** (i) From whom or where the audited financial statements are available; or (ii) The law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.
(c)	**Evaluate whether the summary financial statements adequately disclose the applied criteria.**
(d)	**Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be re-calculated from the related information in the audited financial statements.**
(e)	**Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.**
(f)	**Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.**
(g)	**Evaluate whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary financial statements as discussed already.**

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4.4 Form of Opinion

When the auditor has concluded that an unmodified opinion on the summary financial statements is appropriate, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases:

(a) The accompanying summary financial statements are consistent, in all material respects, with the audited financial statements, in accordance with the applied criteria or

(b) The accompanying summary financial statements are a fair summary of the audited financial statements, in accordance with the applied criteria

If law or regulation prescribes the wording of the opinion on summary financial statements in terms that are different from those described above, the auditor shall:

(a) Apply the procedures discussed earlier and any further procedures necessary to enable the auditor to express the prescribed opinion and

(b) Evaluate whether users of the summary financial statements might misunderstand the auditor's opinion on the summary financial statements and, if so, whether additional explanation in the auditor's report on the summary financial statements can mitigate possible misunderstanding.

If, the auditor concludes that additional explanation in the auditor's report on the summary financial statements cannot mitigate possible misunderstanding, the auditor shall not accept the engagement, unless required by law or regulation to do so. An engagement conducted in accordance with such law or regulation does not comply with this SA. Accordingly, the auditor's report on the summary financial statements shall not indicate that the engagement was conducted in accordance with this SA.

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4.5 Auditor's Report on Summary Financial Statements

Elements of the Auditor's Report: The auditor's report on summary financial statements shall include the following elements: -

(a) A title clearly indicating it as the report of an independent auditor.

(b) An addressee: If the addressee of the summary financial statements is not the same as the addressee of the auditor's report on the audited financial statements, the auditor shall evaluate the appropriateness of using a different addressee. Factors that may affect the auditor's evaluation of the appropriateness of the addressee of the summary financial statements include the terms of the engagement, the nature of the entity, and the purpose of the summary financial statements.

(c) Identification of the summary financial statements on which the auditor is reporting, including the title of each statement, included in the summary financial statements - *When the auditor is aware that the summary financial statements will be included in a document that contains information other than the summary financial statements and the auditor's report thereon, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the summary financial statements are presented. This helps readers identify the summary financial statements to which the auditor's report relates.*

(d) Identification of the audited financial statements.

(e) A clear expression of an opinion.

(f) A statement indicating that the summary financial statements do not contain all the disclosures required by the financial reporting framework applied in the preparation of the audited financial statements and that reading the summary financial statements and the auditor's report thereon is not a substitute for reading the audited financial statements and the auditor's report thereon.

(g) If required, then a statement that the summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements.

(h) Reference to the auditor's report on the audited financial statements, the date of that report, and the fact that an unmodified opinion is expressed on the audited financial statements.

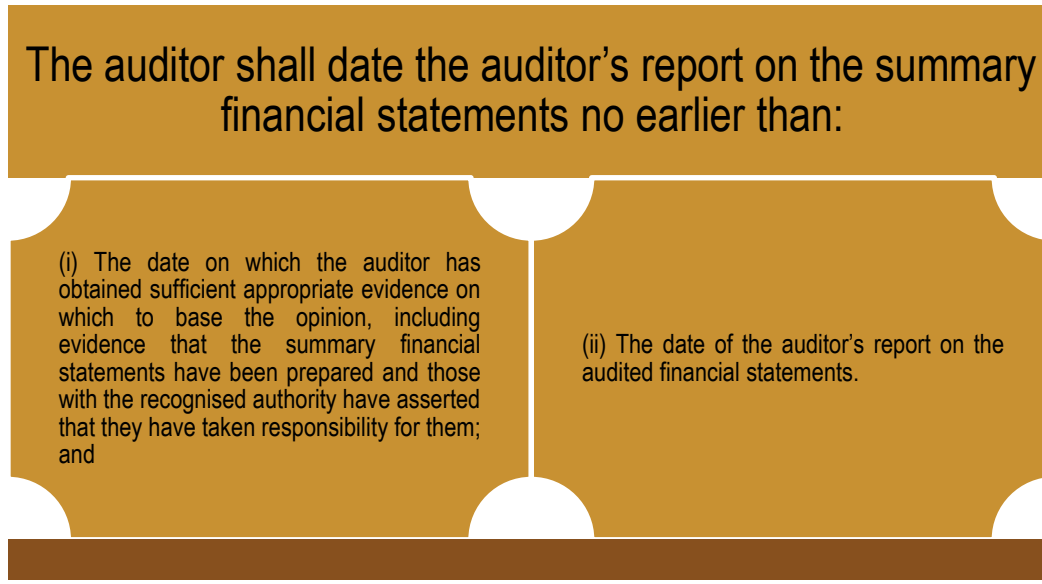
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(i) **A description of management's responsibility for the summary financial statements, explaining that management is responsible for the preparation of the summary financial statements in accordance with the applied criteria.**

(j) **A statement that the auditor is responsible for expressing an opinion, based on the auditor's procedures conducted in accordance with this SA, on whether the summary financial statements are consistent, in all material respects, with [or are a fair summary of] the audited financial statements.**

(k) **The auditor's signature along with the firm registration number, wherever applicable, and the membership number assigned by the Institute of Chartered Accountants of India. Besides, UDIN is required to be stated.**

(l) **The date of the auditor's report**



(m) **The place of signature.**

4.6 Modifications to the Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Audited Financial Statements

Reference to the Auditor's Report on the Audited Financial Statements : When the auditor's report on the audited financial statements includes:
(a) a qualified opinion in accordance with SA 705(Revised);

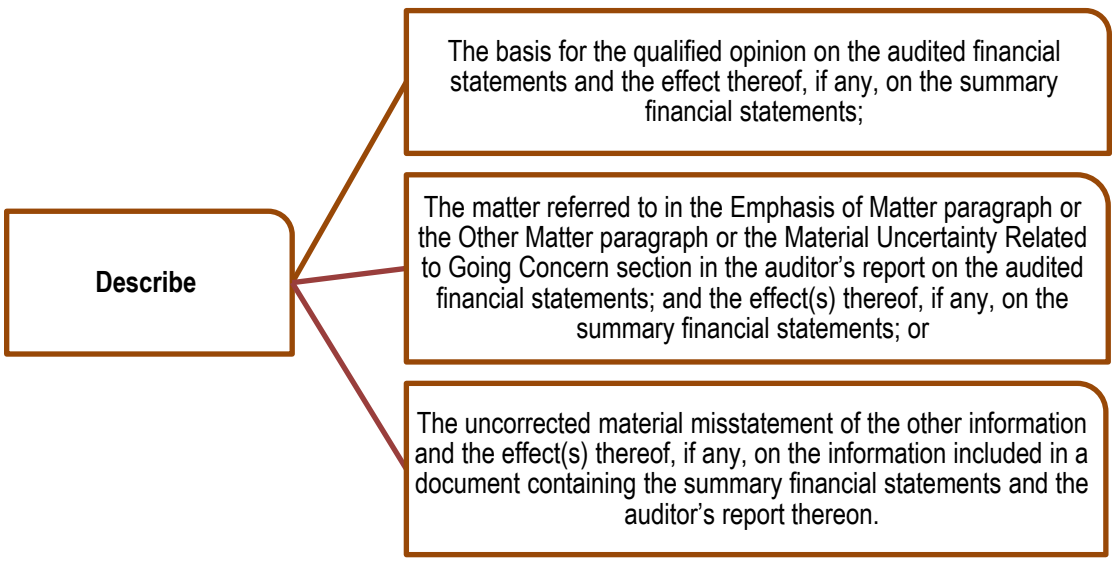
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(b) an Emphasis of Matter paragraph, or an Other Matter paragraph in accordance with SA 706(Revised);
(c) A Material Uncertainty Related to Going Concern section in accordance with SA 570(Revised);
(d) Communication of key audit matters in accordance with SA 701; or
(e) A statement that describes an uncorrected material misstatement of the other information in accordance with SA 720(Revised);

and the auditor is satisfied that the summary financial statements are consistent, in all material respects, with or are a fair summary of the audited financial statements, in accordance with the applied criteria, the auditor's report on the summary financial statements shall, in addition to the elements discussed above:

(a) State that the auditor's report on the audited financial statements includes a qualified opinion, an Emphasis of Matter paragraph, an Other Matter paragraph, a Material Uncertainty Related to Going Concern section, communication of key audit matters, or a statement that describes an uncorrected material misstatement of the other information; and

(b) Describe:



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When the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion, the auditor's report on the summary financial statements shall, in addition to the elements :

State that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion;	Describe the basis for that adverse opinion or disclaimer of opinion; and	State that, as a result of the adverse opinion or disclaimer of opinion on the audited financial statements, it is inappropriate to express an opinion on the summary financial statements.

4.6.1 Modified Opinion on the Summary Financial Statements

If the summary financial statements are not consistent, in all material respects, with or are not a fair summary of the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor shall express an adverse opinion on the summary financial statements.

4.7 Restriction on Distribution or Use or Alerting Readers to the Basis of Accounting

When distribution or use of the auditor's report on the audited financial statements is restricted, or the auditor's report on the audited financial statements alerts readers that the audited financial statements are prepared in accordance with a special purpose framework, the auditor shall include a similar restriction or alert in the auditor's report on the summary financial statements.

4.8 Comparatives

If the audited financial statements contain comparatives, but the summary financial statements do not, the auditor shall determine whether such omission is reasonable in the circumstances of the engagement. The auditor shall determine the effect of an unreasonable omission on the auditor's report on the summary financial statements.

If the summary financial statements contain comparatives that were reported on by another auditor, the auditor's report on the summary financial statements shall also contain the matters that SA 710 requires the auditor to include in the auditor's report on the audited financial statements.

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4.9 Unaudited Supplementary Information Presented With Summary Financial Statements

The auditor shall evaluate whether any unaudited supplementary information presented with the summary financial statements is clearly differentiated from the summary financial statements. If the auditor concludes that the entity's presentation of the unaudited supplementary information is not clearly differentiated from the summary financial statements, the auditor shall ask management to change the presentation of the unaudited supplementary information. If management refuses to do so, the auditor shall explain in the auditor's report on the summary financial statements that such information is not covered by that report.

4.10 Information in Documents Containing Summary Financial Statements

The auditor shall read the information included in a document containing the summary financial statements and the auditor's report thereon and consider whether there is a material inconsistency between that information and the summary financial statements.

If the auditor identifies a material inconsistency, the auditor shall discuss the matter with management and determine whether the summary financial statements or the information included in the document containing the summary financial statements and the auditor's report thereon needs to be revised. If the auditor determines that the information needs to be revised and management refuses to revise the information as necessary, the auditor shall take appropriate action in the circumstances, including considering the implications for the auditor's report on the summary financial statements.

4.11 Auditor Association

If the auditor becomes aware that the entity plans to state that the auditor has reported on summary financial statements in a document containing the summary financial statements, but does not plan to include the related auditor's report, the auditor shall request management to include the auditor's report in the document. If management does not do so, the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document.

The auditor may be engaged to report on the financial statements of an entity, while not engaged to report on the summary financial statements. If, in this case, the auditor becomes aware that the entity plans to make a statement in a document that refers to the

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auditor and the fact that summary financial statements are derived from the financial statements audited by the auditor, the auditor shall be satisfied that:
(a) The reference to the auditor is made in the context of the auditor's report on the audited financial statements; and
(b) The statement does not give the impression that the auditor has reported on the summary financial statements.

If (a) or (b) are not met, the auditor shall request management to change the statement to meet them, or not to refer to the auditor in the document. Alternatively, the entity may engage the auditor to report on the summary financial statements and include the related auditor's report in the document. If management does not change the statement, delete the reference to the auditor, or include an auditor's report on the summary financial statements in the document containing the summary financial statements, the auditor shall advise management that the auditor disagrees with the reference to the auditor, and the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately referring to the auditor.

4.12 Timing of Work and Events Subsequent to the Date of the Auditor's Report on the Audited Financial Statements

The auditor's report on the summary financial statements may be dated later than the date of the auditor's report on the audited financial statements. In such cases, the auditor's report on the summary financial statements shall state that the summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements.

The auditor may become aware of facts that existed at the date of the auditor's report on the audited financial statements but of which the auditor previously was unaware. In such cases, the auditor shall not issue the auditor's report on the summary financial statements until the auditor's consideration of such facts in relation to the audited financial statements in accordance with SA 560 has been completed.

When the auditor reports on the summary financial statements after the completion of the audit of the financial statements, the auditor is not required to obtain additional audit evidence on the audited financial statements, or report on the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements since the summary financial statements are derived from the audited financial statements.

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TEST YOUR UNDERSTANDING 5

CA Madhur is auditor of a company and has issued audit report dated 15th June of a particular year. The audit report on summary financial statements derived from such audited financial statements is dated 15th July of that particular year. Discuss whether there exists any additional reporting responsibility for auditor in such a situation in respect of audit report on summary financial statements.

TEST YOUR UNDERSTANDING 6

Consider that the audit report on financial statements issued by CA Madhur for above said company contains qualified opinion. Can he issue an unmodified opinion on summary financial statements derived from audited financial statements? Discuss.

INTEGRATED CASE SCENARIO

Given below is an extract of abridged financial statements of schemes of ***"Smart Investment Mutual Fund".*** The abridged financial statements have been derived from audited financial statements of the schemes of ***"Smart Investment Mutual Fund"*** as at 31St March 20XX and for year ended 31st March,20XX.

Abridged Balance sheet as at 31st March 20XX ***(in ₹ Lacs)***

Liabilities	***Smart investment equity and debt fund***	***Smart investment equity savings fund***
Unit Capital	20000.00	15000.00
Reserve and Surplus	160000.00	80000.00
Other current liabilities & provisions	100.00	100.00
Total	***180100.00***	***95100.00***
Assets		
Investments	170000.00	90000.00
Deposits	100.00	100.00
Other Current assets	10000.00	5000.00
Total	***180100.00***	***95100.00***

Abridged revenue account for year ended 31st March 20XX (In ₹ Lacs)

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Income	***Smart investment equity and debt fund***	***Smart investment equity savings fund***
Income	34000.00	1000.00
Expenses and losses	3400.00	1500.00
Net realized gains	30600.00	(500.00)
Add: Change in unrealized appreciation in value of investments	2000.00	700.00
Net Surplus	32600.00	200.00
Dividend appropriation	3000.00	50.00
Retained Surplus	29600.00	150.00

The abridged financial statements of the Schemes of the Fund have been prepared by Board of Trustees of Fund pursuant to SEBI regulations and in accordance with format prescribed by SEBI. Previous year figures have been ignored for purpose of case.

Unmodified opinion has been expressed by auditor in audited financial statements of the schemes of ***"Smart Investment Mutual Fund"*** as at 31St March 20XX and for year ended 31st March, 20XX.

Keeping in view above, answer the following questions: -

1. Given the above extract of abridged financial statements and description, which of the following statements is most appropriate?

(a) The auditor may presume that criteria applied by the Board of Trustees in the preparation of the abridged financial statements are acceptable.

(b) The auditor cannot presume that criteria applied by the Board of Trustees in preparation of abridged financial statements are acceptable.

(c) The abridged financial statements have been prepared by the Board of Trustees. The auditor cannot ordinarily accept criteria applied by them for the preparation of such abridged financial statements before detailed evaluation.

(d) The auditor is duty bound to accept the criteria applied by the Board of Trustees in the preparation of abridged financial statements.

2. Which of the following statements in reference to abridged financial statements is not in accordance with the requirements of SA 810?

(a) The notes to accounts should specifically disclose that these abridged financial statements have been derived from audited financial statements.

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(b) The Board of Trustees has disclosed that audited financial statements are available on the website of the company.

(c) It should be stated in the auditor's report that abridged financial statements have been compared with the related information in the audited financial statements to determine whether the abridged financial statements agree with or can be re-calculated from the related information in the audited financial statements.

(d) It should be stated in auditor's report that reading the abridged financial statements is not a substitute for reading the audited financial statements of the Schemes of the Fund.

3. Which of the following paras is most appropriate to be included under heading "Auditor's responsibility" in the auditor's report?

(a) Our responsibility is to express an opinion on the Abridged financial statements based on our procedures, which were conducted in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India.

(b) Our responsibility is to express an opinion on the Abridged financial statements based on our procedures, which were conducted in accordance with Standard on Auditing (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

(c) Our responsibility is to express an opinion on the Abridged financial statements based on our procedures, which were conducted in accordance with Standards on Auditing adapted in circumstances including (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

(d) Our responsibility is to express an opinion on the Abridged financial statements based on our procedures, which were conducted in accordance with SEBI regulations and Standards on Auditing adapted in circumstances including (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

4. Which of the following paras is most appropriate to be included under heading "Opinion" in auditor's report?

(a) In our opinion, the abridged financial statements, derived from the audited financial statements of the Schemes of the Fund as at March 31, 20XX and for the year ended March 31, 20XX are a fair summary of those financial statements, and are in accordance with the accounting policies and standards specified in SEBI regulations and generally accepted accounting principles in India to the extent applicable.

(b) In our opinion, the abridged financial statements, as at March 31, 20XX and for the year ended March 31, 20XX are a fair summary of those financial statements.

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(c) In our opinion, the abridged financial statements, derived from the audited financial statements of the Schemes of the Fund as at March 31, 20XX and for the year ended March 31, 20XX are consistent with audited financial statements and are in accordance with the accounting policies and standards specified in SEBI regulations and generally accepted accounting principles in India to the extent applicable.

(d) In our opinion, the abridged financial statements, derived from the audited financial statements of the Schemes of the Fund as at March 31, 20XX and for the year ended March 31, 20XX are consistent with audited financial statements.

5. Which of the following is usually not an element of audit report on abridged financial statements in accordance with SA 810?

(a) Emphasis of Matter paragraph.

(b) Other Matter paragraph.

(c) Management's responsibility for abridged financial statements.

(d) Key Audit Matters.

Key Takeaways

- SA 800 deals with special considerations applicable in respect of audit of financial statements prepared in accordance with special purpose framework.
- SA 800 defines special purpose framework as a financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.
- SA 800 addresses special considerations that are relevant to the acceptance of the engagement, the planning and performance of that engagement and forming an opinion and reporting on the financial statements but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.
- The special purpose financial statements may be used for purposes other than those for which they were intended. To avoid misunderstandings, the auditor alerts users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework and, therefore, may not be suitable for another purpose.
- SA 805 deals with special considerations applicable to an audit of a single financial statement or of a specific element, account or item of a financial statement.

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- The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, SA 800 also applies to such an audit of a single financial statement or of a specific element, account or item of a financial statement.
- Single financial statement is to be distinguished from complete set of financial statements. For example, a cash flow statement is a single financial statement.
- "Element of a financial statement" or "element" means an "element, account or item of a financial statement." For example, trade receivables or cash and bank balances.
- The objective of the auditor, when applying SAs, in such an audit, is to address appropriately the special considerations that are relevant to acceptance of engagement, planning and performance of engagement and forming an opinion and reporting but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.
- In planning and performing the audit of a single financial statement or of a specific element of a financial statement, the auditor shall adapt all SAs relevant to the audit as necessary in the circumstances of the engagement.
- If the auditor undertakes an engagement to report on a single financial statement or on a specific element of a financial statement in conjunction with an engagement to audit the entity's complete set of financial statements, the auditor shall express a separate opinion for each engagement.
- SA 810 deals with responsibilities of an auditor when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor.
- Summary financial statements reflect historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time.
- The auditor shall, ordinarily, accept an engagement to report on summary financial statements in accordance with this SA only when the auditor has been engaged to conduct an audit in accordance with SAs of the financial statements from which the summary financial statements are derived.

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- Before accepting an engagement to report on summary financial statements, the auditor shall determine whether the applied criteria are acceptable. Applied criteria refer to the criteria applied by management in the preparation of the summary financial statements.
- If the date of the auditor's report on the summary financial statements is later than the date of the auditor's report on the audited financial statements, auditor's report on summary financial statements states that the summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *CA P is auditor of a company responsible for auditing the complete set of financial statements. He intends to express adverse opinion on complete set of financial statements considering conclusions drawn by him during course of audit. He is also auditing trade receivables of company for the same period in a separate engagement. Can he express an unmodified opinion in respect of trade receivables? If so, discuss those circumstances.*

2. *SA 800 deals with special considerations applicable in respect of audit of financial statements prepared in accordance with special purpose framework. Explain, by giving examples, the meaning of special purpose framework.*

3. *CA Y is auditor of a company. He has expressed adverse opinion on audited financial statements. What additional points he has to keep in mind while expressing opinion on summary financial statements derived from such audited financial statements?*

4. ***CA Y is the auditor of Stekk Ltd., a company that recently faced material misstatements in its financial records, leading to an adverse opinion on the audited financial statements for the financial year 2023-24. Now, the management of the company has prepared summary financial statements derived from the audited financial statements and requested CA Y to express his opinion on these summaries. What additional points should CA Y consider when expressing an opinion on these summary financial statements?***

5. ***Mr. BK has been engaged by XYZ Ltd. to report on summary financial statements derived from the financial statements audited by him in accordance with SAs. Mr. BK wants to determine whether the applied criteria are acceptable before accepting such***

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assignment. Guide him the factors affecting auditor's determination of the acceptability of applied criteria as per relevant Standard on Auditing.

6. ***When auditor's report on the audited financial statements contains a qualified opinion, but the auditor is satisfied that the summary financial statements are a fair summary of the audited financial statements, in accordance with the applied criteria, which other matters shall the auditor's report on the summary financial statements contain in addition to elements of auditor's report described in SA 810?***

   If summary financial statements are not a fair summary of the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, what are implications for auditor's opinion on summary financial statements?

Answers to Test Your Understanding Questions

1. In the given situation, the approach of CA Lalita is proper. There is no bar upon accepting such an engagement even though she is the auditor of the company. Besides, she has intended to disclose this fact in "Emphasis of Matter Paragraph" of the audit report to be issued by her for such specific engagement.

2. She may consider it appropriate to indicate that the auditor's report is intended solely for specific users. Depending on the law or regulation applicable, this may be achieved by restricting the distribution or use of the auditor's report. In these circumstances, the paragraph alerting the readers may be expanded to include these other matters and the heading modified accordingly. The draft para should read as under: -

> ***Basis of Accounting and Restriction on Distribution and Use***
>
> Without modifying our opinion, we draw attention to Note A to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the company to comply with the financial reporting provisions of the contract referred to above. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for X Ltd. and Y Ltd. and should not be distributed to or used by parties other than X Ltd. and Y Ltd.

3. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, SA 800 also applies to the audit.

In the given case, financial statements of the entity are prepared in accordance with financial reporting provisions of a contract. It is a special purpose framework. The auditor of financial

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statements prepared in accordance with the special purpose framework is also offered to audit trade receivables appearing in the above financial statements, which relate to the audit of the elements of financial statements prepared in accordance with the special purpose framework. Hence, his audit approach should include considering requirements of both SA 800 and SA 805.

4. Compliance with the requirements of SAs relevant to the audit of a single financial statement or of a specific element of a financial statement may not be practicable when the auditor is not also engaged to audit the entity's complete set of financial statements. In such cases, the auditor often does not have the same understanding of the entity and its environment, including its internal control, as an auditor who also audits the entity's complete set of financial statements. Accordingly, the auditor may need further evidence to corroborate audit evidence acquired from the accounting records.

In the case of an audit of a specific element of a financial statement, certain SAs require audit work that may be disproportionate to the element being audited. If the auditor concludes that an audit of a single financial statement or of a specific element of a financial statement in accordance with SAs may not be practicable, the auditor may discuss with management whether another type of engagement might be more practicable.

5. The audit report on summary financial statements derived from audited financial statements is dated 15th July of that particular year. However, the audit report on audited financial statements is dated 15th June of that year.

In the above situation, the auditor's report on summary financial statements should state that the summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements.

6. If the auditor is satisfied that the summary financial statements are consistent, in all material respects, with or are a fair summary of the audited financial statements, in accordance with the applied criteria, he can issue an unmodified opinion.

However, when auditor's report on audited financial statements contains a qualified opinion, the auditor's report on the summary financial statements shall, also contain following:

(a) State that the auditor's report on the audited financial statements contains a qualified opinion

(b) Describe:

(i) The basis for the qualified opinion on the audited financial statements, and that qualified opinion in the auditor's report on the audited financial statements; and

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(ii) The effect thereof on the summary financial statements, if any.

Hence, above points should be included by CA Madhur.

Answers to Case Scenario

1. (a) **2.** (c) **3.** (b) **4.** (a) **5.** (d)

Answers to Theoretical Questions

1. Refer to Para 3.6.

2. Refer to Para 2.1.

3. Refer to Para 4.6.

4. Refer to Para 4.6

5. In the given situation, Mr. BK has been engaged by XYZ Ltd. to report on summary financial statements derived from the financial statements audited by him in accordance with SAs. Mr. BK wants to determine whether the applied criteria are acceptable before accepting such assignment.

As per SA 810, "Engagements to Report on Summary Financial Statements", before accepting an engagement to report on summary of financial statements, the auditor shall determine whether applied criteria are acceptable. 'Applied criteria' refers to the criteria applied by management in the preparation of the summary financial statements.

Factors affecting the auditor's determination of the acceptability of the applied criteria are:

- ***The nature of the entity;***
- ***The purpose of the summary financial statements;***
- ***The information needs of the intended users of the summary financial statements; and***
- ***Whether the applied criteria will result in summary financial statements that are not misleading in the circumstances.***

6. Refer to Para 4.2.

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CHAPTER 9

RELATED SERVICES



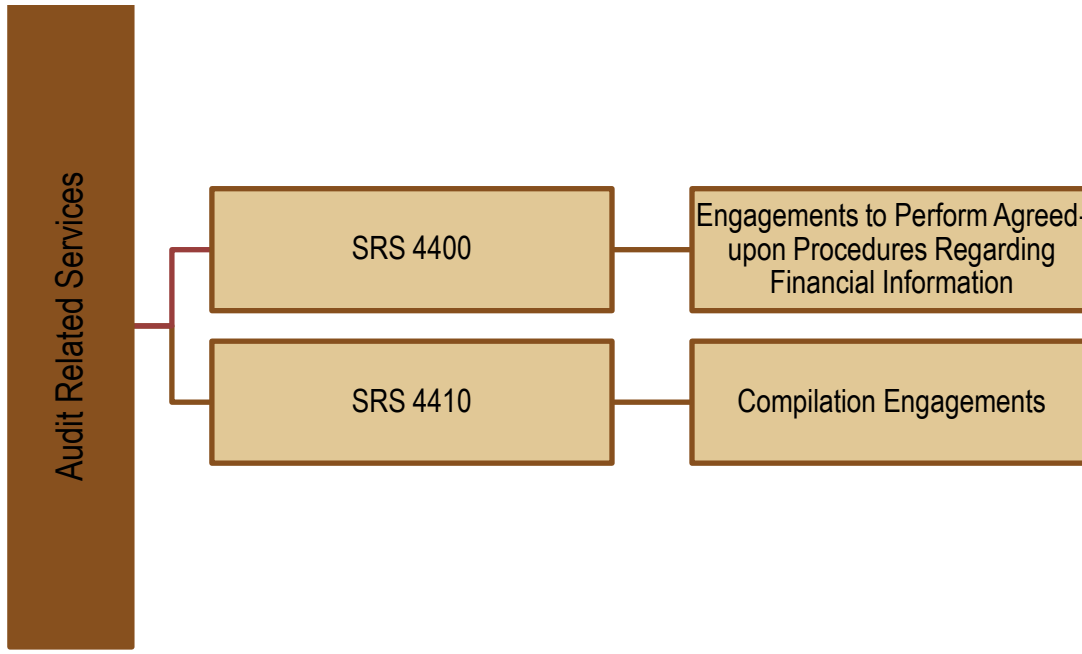
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand meaning of "Related Services".
- Know about Standards on Related Services.
- Understand nature of "Agreed-Upon Procedures".
- Gain knowledge about SRS 4400 Engagements to Perform Agreed-upon Procedures regarding Financial Information.
- Understand reporting requirements of SRS 4400.
- Understand meaning and nature of "Compilation engagement".
- Gain knowledge about SRS 4410 Compilation Engagements.
- Understand reporting requirements of SRS 4410.

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CHAPTER OVERVIEW



Trends Multi Products Limited is engaged in the business of selling ethnic items. It involves procuring of myriad stocks ranging from brassware, wooden to handloom home furnishings and exotic handicrafts through a chain of dealers, who in turn, purchase these items directly from artisans, weavers and tiny enterprises. Since procurement is done at multiple locations all over the country, the company has set up an extensive system of inventory control.

Considering huge inventories at multiple locations and associated risks, it requests CA Shaan to undertake an exercise involving physical verification of inventories and its reconciliation with inventory records for a handsome professional fee. The management also offers suitable staff resources support to perform required procedures. Such an exercise has to be performed in accordance with prevailing professional standards and management wants a report in accordance with professional standards applicable to such engagements.

Drawn to such a work due to attractive fees offered, CA Shaan is on two boats. At first place, he is thinking whether such an engagement can be accepted at all. Even if it is to be accepted, what should be the expected form and content of the report? Since engagement is to be performed in accordance with professional standards, SA 501 instantly came to his mind.

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Immediately, a pack of thoughts obliterated this. SA 501 applies to audit of financial statements-in part- for obtaining audit evidence pertaining to existence and condition of inventories. Since he is not to conduct audit of financial statements of company, how can SA 501 be applicable? However, the outlook of assignment appeared to involve application of procedures of an audit nature for performing it. Is there any Standard for such type of engagements involving performing an agreed-upon procedure where factual findings are to be reported? Whether such engagement would be in nature of assurance engagement or not? Why does company need such type of report? Refining his search, he stumbled upon Standard on Related Services 4400.

Sitting in his air-conditioned office in one sweltering afternoon in Kolkata, he is approached by a client to help it prepare its financial statements. The client is agreeing to provide trial balance and other required information. However, herein lies the catch. Not only client requires his assistance in preparation and presentation of financial statements, but a compilation report is also required.

A similar question struck his mind. Whether such a compilation report would be in nature of assurance report? What kind of responsibilities are entrusted to a professional accountant while performing such an engagement?

1. INTRODUCTION

Chartered Accountants in practice are often asked to provide services to clients which do not involve the expression of an opinion on the truth and fairness of financial statements. For the purpose of standardising the procedures to perform such kind of non-assurance services, the AASB of ICAI issued two Standards on two different services i.e. **Standards on Related Services.**

The following standards have been issued under Standards on Related Services: -

- SRS 4400 Engagements to Perform Agreed-upon Procedures Regarding Financial Information
- SRS 4410 Compilation Engagements

What are Related Services?

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

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are able to make confident decisions knowing well that chance of information being incorrect is diminished.

Not all engagements performed by practitioners are assurance engagements. Other frequently performed engagements that do not meet the definition of assurance engagements include: -
• The preparation of tax returns where no conclusion conveying assurance is expressed.
• Consulting (or advisory) engagements such as management and tax consulting.
• Engagements covered by Standards for Related Services, such as agreed-upon procedures engagements and compilations of financial or other information.

The above engagements are in nature of related services.

What are Agreed-upon Procedures?

In an engagement to perform agreed-upon procedures, the auditor is engaged by the client to issue a report of factual findings, based on specified procedures performed on specified subject matter of specified elements, accounts or items of a financial statement.

For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements.

However, a person performing related services need not necessarily be the auditor of the entity's financial statements.

2. SRS 4400 ENGAGEMENTS TO PERFORM AGREED-UPON PROCEDURES REGARDING FINANCIAL INFORMATION

SRS 4400 provides guidance on the auditor's professional responsibilities when an engagement to perform agreed-upon procedures regarding financial information is undertaken and, on the form, and content of the report that the auditor issues in connection with such an engagement.

2.1 Objective in Accordance with SRS 4400

The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

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As the auditor simply provides a report of the factual findings of agreed upon procedures, no assurance is provided by him in his report. Instead, users of the report assess for themselves the procedures and the findings reported by the auditor and draw their own conclusions from the work done by the auditor.

The report is usually restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

The objective of an agreed-upon procedures engagement is to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. No assurance is provided in such a report. Such agreed-upon procedures engagements are non-assurance engagements.

2.2 Audit Vs. Agreed-upon Procedures

A key difference between an audit and agreed-upon procedures relates to assurance. An audit expresses an opinion and provides assurance to users. However, in an agreed-procedures engagement, only a report of the factual findings of agreed-upon procedures is provided. No assurance is given to users. Instead, users draw their own conclusions based on factual findings stated in the report.

For example, an agreed upon procedures engagement to evaluate validity of accounts payable may state the following:



Comparing of names of major suppliers and the amounts outstanding as on a date to the related names and amounts in the trial balance



Obtaining suppliers statements or confirmations from suppliers to confirm balances outstanding on a date



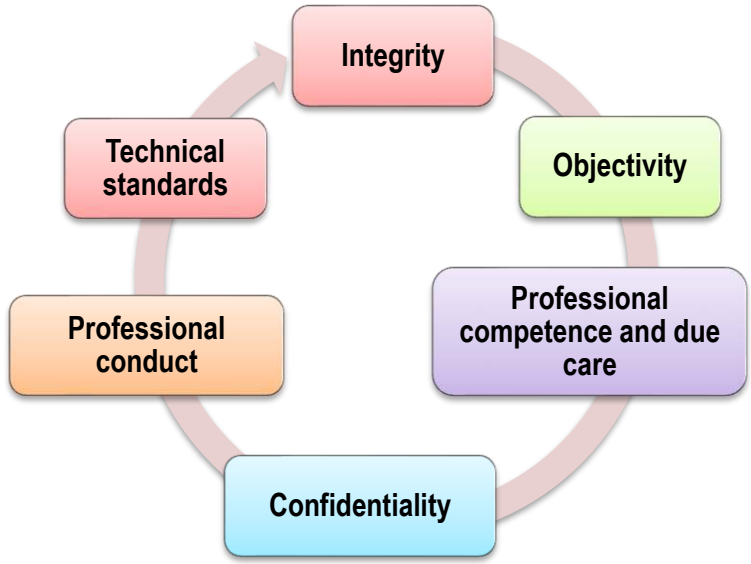
Comparison of such statements or confirmations to the amounts in trial balance

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Further, actual findings like variation in balances reflected in trial balance and statements or confirmations are given. The actual findings are reported as such without providing an assurance.

2.3 General Principles of an Agreed-upon Procedures Engagement

The auditor should comply with the Code of Ethics, issued by the Institute of Chartered Accountants of India. Ethical principles governing the auditor's professional responsibilities for this type of engagement include **integrity, objectivity, professional competence and due care, confidentiality, professional conduct and technical standards**.



Independence is not a requirement for agreed-upon procedures engagement. However, the terms or objective of the engagement may require the auditor to comply with the independence requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India. Where the auditor is not independent, a statement to that effect should be made in the report of factual findings.

2.3.1 Defining the Terms of the Engagement

The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.

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Matters to be agreed include the following

(a) Nature of the engagement including the fact that the procedures performed will not constitute an audit or a review and that accordingly no assurance will be expressed.

(b) Stated purpose for the engagement.

(c) Identification of the financial information to which the agreed-upon procedures will be applied.

(d) Nature, timing and extent of the specific procedures to be applied.

(e) Limitations on distribution of the report of factual findings. When such limitation would be in conflict with the legal requirements, if any, the auditor would not accept the engagement.

It is in the interests of both the client and the auditor that the auditor sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor's responsibilities and the form of reports to be issued.

Matters that would be included in the engagement letter include

- A listing of the procedures to be performed as agreed-upon between the parties.
- A statement that the distribution of the report of factual findings would be restricted to the specified parties who have agreed to the procedures to be performed.

2.3.2 Planning

The auditor should plan the work so that an effective engagement will be performed.

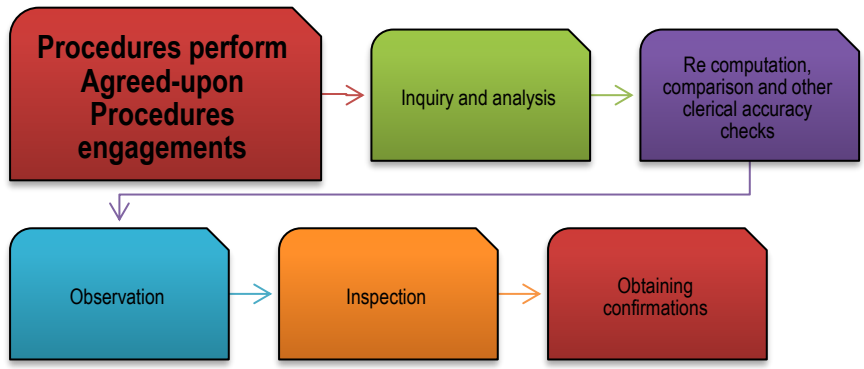
2.3.3 Procedures and Evidence

The auditor should carry out the procedures agreed-upon and use the evidence obtained as the basis for the report of factual findings.

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The procedures applied in an engagement to perform agreed-upon procedures may include:

- Inquiry and analysis
- Re computation, comparison and other clerical accuracy checks
- Observation
- Inspection
- Obtaining confirmations



2.4 Reporting

The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedures of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed. The report should also clearly mention that no audit or review has been performed.

The report of factual findings should contain: -	
(a)	**Title;**
(b)	**Addressee (ordinarily, the appointing authority);**
(c)	**Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;**
(d)	**A statement that the procedures performed were those agreed-upon with the recipient;**
(e)	**A statement that the engagement was performed in accordance with the Standard on Related Services applicable to agreed-upon procedures engagements;**
(f)	**Identification of the purpose for which the agreed-upon procedures were performed;**

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(g)	A listing of the specific procedures performed;
(h)	A description of the auditor's factual findings including sufficient details of errors and exceptions found;
(i)	A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;
(j)	A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;
(k)	A statement that the report is restricted to those parties that have agreed to the procedures to be performed;
(l)	A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole;
(m)	Date of the report;
(n)	Place of signature; and
(o)	Auditor's signature

2.5 Documentation

The auditor should document matters which are important in providing evidence to support the report of factual findings, and evidence that the engagement was carried out in accordance with this SRS and the terms of the engagement.

TEST YOUR UNDERSTANDING 1

A company asks you to carry out the process of confirmation of its accounts receivables having balances in excess of ₹ 10 lacs as per its books of accounts at the close of the year. The work to be performed only involves preparing and sending confirmation requests to such parties, analysis of variations on receipt of confirmations and submission of a report in accordance with professional standards. What points have to be kept in mind for inclusion in the report specifically for such engagement?

3. SRS 4410 COMPILATION ENGAGEMENTS

SRS 4410 deals with the practitioner's responsibilities when engaged to assist management with the preparation and presentation of historical financial information without obtaining any assurance on that information, and to report on the engagement in accordance with this SRS.

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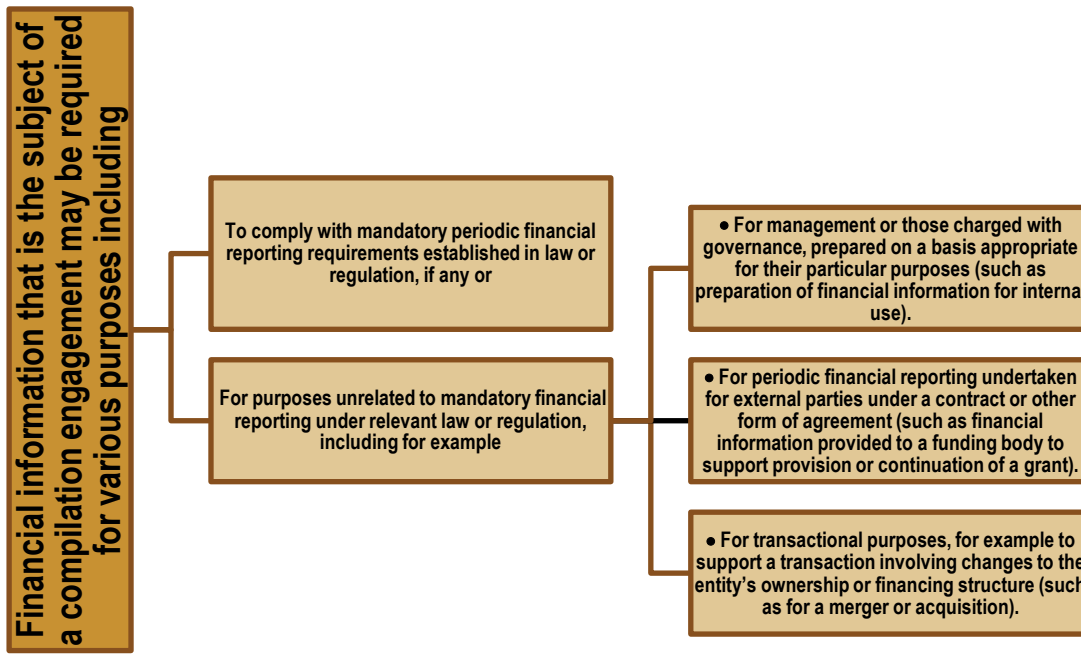
It applies to compilation engagements for historical financial information. Compilation engagements for financial information other than historical financial information, and compilation engagements for non-financial information can be performed under this Standard after necessary adaptation.

SQC 1 is applicable to all Engagement Standards. Since SRS 4410 is also one of Engagement Standards, SQC 1 applies to firms in respect of firm's compilation engagements too.

What is a Compilation engagement?

Compilation engagement is an engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework and issues a report.

Management may request a professional accountant in public practice to assist with the preparation and presentation of financial information of an entity.

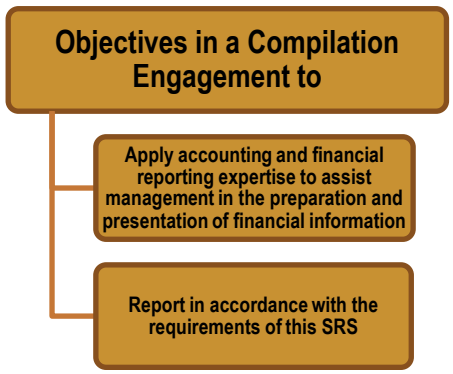


A compilation engagement is not an assurance engagement. A compilation engagement does not require the practitioner to verify the accuracy or completeness of the information provided by management for the compilation, or otherwise to gather evidence to express an audit opinion or a review conclusion on the preparation of the financial information.

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3.1 Objectives in accordance with SRS 4410

The practitioner's objectives in a compilation engagement under this SRS are to: -



(a) Apply accounting and financial reporting expertise to assist management in the preparation and presentation of financial information in accordance with an applicable financial reporting framework based on information provided by management and

(b) Report in accordance with the requirements of this SRS.

3.2 Scope of Compilation Engagements

The scope of a compilation engagement will vary depending on the circumstances of the engagement. However, in every case it will involve assisting management in the preparation and presentation of the entity's financial information in accordance with the financial reporting framework, based on information provided by management. In some compilation engagements, management may have already prepared the financial information itself in a draft or preliminary form.

Management retains responsibility for the financial information and the basis on which it is prepared and presented. That responsibility includes application by management of the judgment required for the preparation and presentation of the financial information, including the selection and application of appropriate accounting policies and, where needed, developing reasonable accounting estimates.

Different financial reporting frameworks can be used to prepare and present financial information, ranging from a simple entity-specific basis of accounting to established financial reporting standards. The financial reporting framework adopted by management to prepare and present the financial information will depend on the nature of the entity and the intended use of the information.

3.3 Ethical Requirements

The practitioner shall comply with relevant ethical requirements. In complying with the Code of Ethics, threats to the practitioner's compliance with relevant ethical requirements are required to be identified and appropriately addressed.

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Being in nature of non-assurance engagement, independence requirements do not apply to compilation engagements. However, laws or regulations may specify requirements or disclosure rules pertaining to independence.

3.4 Engagement Acceptance and Continuance

The practitioner shall not accept the engagement unless the practitioner has agreed the terms of engagement with management, and the engaging party if different, including: -

(a) The intended use and distribution of the financial information, and any restrictions on either its use or its distribution where applicable.
(b) Identification of the applicable financial reporting framework.
(c) The objective and scope of the compilation engagement.
(d) The responsibilities of the practitioner, including the requirement to comply with relevant ethical requirements.
(e) The responsibilities of management for

Management is responsibile for

(i) The financial information, and for the preparation and presentation thereof, in accordance with a financial reporting framework that is acceptable in view of the intended use of the financial information and the intended users	(ii) Design, implementation and maintenance of such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error	(iii) The accuracy and completeness of the records, documents, explanations and other information provided by management for the compilation engagement and	(iv) Judgments needed in the preparation and presentation of the financial information, including those for which the practitioner may provide assistance in the course of the compilation engagement

(f) The expected form and content of the practitioner's report.

The practitioner shall record the agreed terms of engagement in an engagement letter or other suitable form of written agreement, prior to performing the engagement.

On recurring compilation engagements, the practitioner shall evaluate whether circumstances, including changes in the engagement acceptance considerations, require the terms of engagement to be revised and whether there is need to remind management of the existing terms of engagement.

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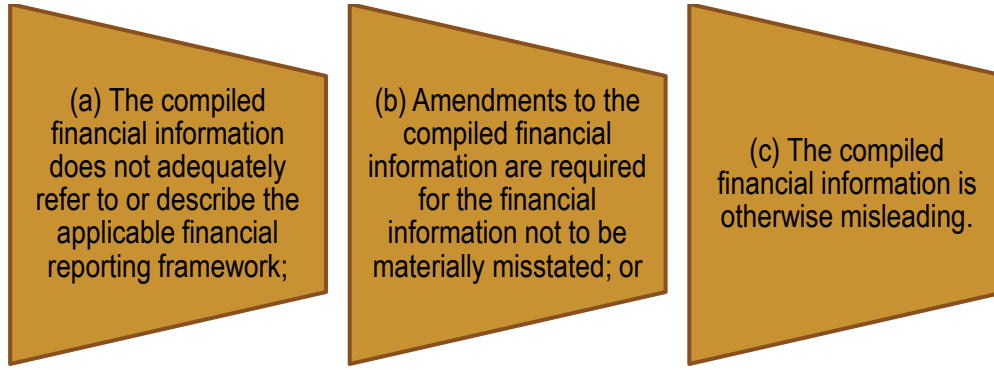
3.5 Performing the Engagement

- The practitioner shall **obtain an understanding** of the following matters sufficient to be able to perform the compilation engagement: -

> (a) The entity's business and operations, including the entity's accounting system and accounting records and
>
> (b) The applicable financial reporting framework, including its application in the entity's industry.

- The practitioner shall **compile the financial information** using the records, documents, explanations and other information, including significant judgments, provided by management.
- The practitioner shall **discuss with management, or those charged with governance** as appropriate, those significant judgments, for which the practitioner has provided assistance in the course of compiling the financial information.
- Prior to completion of the compilation engagement, the practitioner shall **read the compiled financial information in light of the practitioner's understanding of the entity's business and operations, and of the applicable financial reporting framework**.
- If, in the course of the compilation engagement, the practitioner becomes aware that the records, documents, explanations or other information, including significant judgments, provided by management for the compilation engagement are incomplete, inaccurate or otherwise unsatisfactory, the practitioner shall bring that to the attention of management and request the additional or corrected information.
- If the practitioner is **unable to complete the engagement** because management has failed to provide records, documents, explanations or other information, including significant judgments, as requested, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.
- If the practitioner becomes aware during the course of the engagement that: -

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the practitioner shall propose the appropriate amendments to management.

- If management declines, or does not permit the practitioner to make the proposed amendments to the compiled financial information, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.
- If withdrawal from the engagement is not possible, the practitioner shall determine the professional and legal responsibilities applicable in the circumstances.
- The practitioner shall obtain an acknowledgement from management or those charged with governance, as appropriate, that they have taken responsibility for the final version of the compiled financial information.

3.6 Communication with Management and Those Charged with Governance

The practitioner shall communicate with management or those charged with governance, as appropriate, on a timely basis during the course of the compilation engagement, all matters concerning the compilation engagement that, in the practitioner's professional judgment, are of sufficient importance to merit the attention of management or those charged with governance, as appropriate.

3.7 The Practitioner's Report

An important purpose of the practitioner's report is to clearly communicate the nature of the compilation engagement, and the practitioner's role and responsibilities in the engagement. *The practitioner's report is not a vehicle to express an opinion or conclusion on the financial information in any form.*

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The practitioner's report issued for the compilation engagement shall be in writing, and shall include the following elements: -		
(a)	The report title;	
(b)	The addressee(s), as required by the terms of the engagement;	
(c)	A statement that the practitioner has compiled the financial information based on information provided by management;	
(d)	A description of the responsibilities of management, or those charged with governance as appropriate, in relation to the compilation engagement, and in relation to the financial information;	
(e)	Identification of the applicable financial reporting framework and, if a special purpose financial reporting framework is used, a description or reference to the description of that special purpose financial reporting framework in the financial information;	
(f)	Identification of the financial information, including the title of each element of the financial information if it comprises more than one element, and the date of the financial information or the period to which it relates;	
(g)	A description of the practitioner's responsibilities in compiling the financial information, including that the engagement was performed in accordance with this SRS, and that the practitioner has complied with relevant ethical requirements;	
(h)	A description of what a compilation engagement entails in accordance with this SRS;	
(i)	**Explanations that: -**	
	(i) Since a compilation engagement is not an assurance engagement, the practitioner is not required to verify the accuracy or completeness of the information provided by management for the compilation; and	(ii) Accordingly, the practitioner does not express an audit opinion or a review conclusion on whether the financial information is prepared in accordance with the applicable financial reporting framework.
(j)	**If the financial information is prepared using a special purpose financial reporting framework, an explanatory paragraph that:**	

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	(i) Describes the purpose for which the financial information is prepared and, if necessary, the intended users, or contains a reference to a note in the financial information that discloses this information; and	(ii) Draws the attention of readers of the report to the fact that the financial information is prepared in accordance with a special purpose framework and that, as a result, the information may not be suitable for other purposes;
(k)	The date of the practitioner's report;	
(l)	The practitioner's signature; and	
(m)	The place of signature.	

3.8 Engagement Level Quality Control

The engagement partner shall take responsibility for: -

(a) The overall quality of each compilation engagement to which that partner is assigned and

(b) The engagement being performed in accordance with the firm's quality control policies and procedures

3.9 Documentation

The practitioner shall include in the engagement documentation: -	
(a)	Significant matters arising during the compilation engagement and how those matters were addressed by the practitioner
(b)	A record of how the compiled financial information reconciles with the underlying records, documents, explanations and other information, provided by management and
(c)	A copy of the final version of the compiled financial information for which management or those charged with governance, as appropriate, has acknowledged their responsibility, and the practitioner's report.

The practitioner may consider also including in the engagement documentation a copy of the entity's trial balance, summary of significant accounting records or other information that the practitioner used to perform the compilation.

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TEST YOUR UNDERSTANDING 2

During the course of performing a compilation engagement in accordance with SRS 4410, it becomes known to you that the client had suffered a theft loss of ₹ 100 lacs of its inventories over a period of time at a storage location visited infrequently. A claim was lodged by the client with the insurance company which was repudiated due to certain technical reasons relating to coverage of policy. The client has not preferred a complaint or an appeal against said repudiation. The amount is reflected under the head "current assets" in trial balance of the client. Discuss how you should proceed to deal with the matter?

INTEGRATED CASE SCENARIO

KM Limited has engaged your firm for compilation of financial statements in accordance with requirements of SRS 4410. You also come to know that company is setting up a new unit in Rourkela, Odisha. The company management has provided you with draft trial balance and requires assistance in preparation and presentation of its financial statements for year ended 31st March, 2024. The management requires such a preparation and presentation for its internal use.

During the course of engagement, it is noticed that: -

[1] There are apparent errors in few opening balances brought forward from previous year relating to some outstanding incentives receivable from government authorities. These have been swapped with some other balances in trial balance. However, there are no credit transactions in such incentive accounts or accounts whose balances have been swapped during the year.

[2] One of the team members suggests that it is one of the duties to ensure that revenue figures stated in trial balance, at least, are verified to ensure that all revenues required to be booked by the company have, in fact, been booked.

[3] It is also suggested by this team member that even though it is a compilation engagement, quality control aspects like adhering to appropriate Standards needed to be followed.

[4] Before signing and issuing report under SRS 4410, you once again read the financial information. It comes to your notice that figures relating to setting up of a new unit of the company coming up in Rourkela in Odisha have not been properly disclosed in compiled financial statements. The expenditure was incurred from a bank account maintained in Rourkela and was omitted to be shown under appropriate heads. You are vacillating regarding above considering scope of compilation engagement.

[5] The team has prepared detailed documentation during the course of engagement.

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Keeping in view above, answer the following questions: -

1. In respect of errors in some of opening balances noticed as described in case, which of the following statements is most appropriate?

(a) Such errors should straight away lead to the qualification of a report to be issued.

(b) Such errors should be brought to the knowledge of management.

(c) Knowledge of such type of errors has no effect on compliance of ethical requirements by the firm.

(d) The above said matter relates to SA 510 Initial Audit Engagements-Opening Balances and has no effect on reporting obligations in a compilation engagement.

2. As regards the suggestion of one of the team members regarding the verification of all revenues of the company, which of the following statements is most appropriate?

(a) Suggestion of team member is proper as such verification is part and parcel of such an engagement.

(b) Suggestion of team member is proper as the absence of such verification may make financial statements misleading.

(c) Suggestion of team member is not proper as verifying the accuracy or completeness of the information provided by management is not required in such engagement.

(d) Suggestion of team member is not proper as compliance with qualitative requirements is not required in such engagement.

3. In view of the team member's suggestion relating to adherence to appropriate Standards for quality control, which of the following statements is relevant in the context of above said engagement?

(a) SA 220 is applicable in this engagement and has to be followed by the engagement partner meticulously.

(b) SQC 1 is applicable in this engagement.

(c) Both SA 220 and SQC 1 are applicable in this engagement.

(d) SA 220 and SQC 1 are not applicable in this engagement. However, SRS 4410 lays down detailed quality control requirements for such type of engagement.

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4. Which of the following statements is most appropriate as regards omission of expenditure under appropriate heads pertaining to the Rourkela unit in compiled financial statements?

(a) The above-noted omission can be misleading. By disregarding such an omission, the fundamental principle of integrity is violated, and engagement cannot be performed in accordance with ethical requirements.

(b) The above-noted omission can be misleading. By disregarding such an omission, the fundamental principle of objectivity is violated, and engagement cannot be performed in accordance with ethical requirements.

(c) The above noted omission has no effect on performing such compilation engagement.

(d) The above-noted omission has no effect on performing and issuing reports under such compilation engagement.

5. The detailed documentation is maintained during the course of compilation engagement. Which of the following statements is most appropriate regarding the assembly of the final engagement file?

(a) Final engagement file should be assembled in not more than 60 days after the date of the report.

(b) Final engagement file should be assembled in not more than 120 days after the date of the report.

(c) Final engagement file should be assembled on a timely basis after the engagement report has been finalised in accordance with the time limits set by the firm.

(d) There is no requirement of assembling of final engagement file in a compilation engagement.

Key Takeaways

- Related Services engagements are not assurance engagements. In such types of engagements, no assurance is provided by the practitioner.
- In an engagement to perform agreed-upon procedures, the auditor is engaged by the client to issue a report of factual findings, based on specified procedures performed on specified subject matter of specified elements, accounts or items of a financial statement.
- SRS 4400 provides guidance on the auditor's professional responsibilities when an engagement to perform agreed-upon procedures regarding financial information is

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undertaken and, on the form, and content of the report that the auditor issues in connection with such an engagement.

- Compilation engagement is an engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework and issues a report.
- SRS 4410 deals with the practitioner's responsibilities when engaged to assist management with the preparation and presentation of historical financial information without obtaining any assurance on that information, and to report on the engagement in accordance with this SRS.
- Engagement documentation has to be maintained for an agreed-upon procedures engagement and compilation engagement.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *List out few intended purposes of a "compilation engagement."*
2. *A Chartered Accountant is offered appointment for a compilation engagement to be performed under SRS 4410. Is he required to comply with the ethical requirements of the Code of Ethics? Discuss briefly.*
3. *How do "related services" differ from assurance engagements?*
4. *Discuss main documentation requirements to be taken care of by a practitioner while performing a compilation engagement under SRS 4410.*
5. *CA P has been appointed to compile the financial information of X Limited. CA P is confused whether he should apply the same procedures which are required to be applied to conduct an audit or there are some other procedures to discharge the duties under such an engagement. Define the characteristics of Compilation Engagement. What should be the approach of CA P for performing the Engagement?*
6. ***MNC Limited has engaged CA Lalit to help the company in compilation of the financial information. CA Lalit explained his team members, the scope of work and the responsibilities under this engagement. The team members have done mostly audit engagements and do not have exposure to compilation engagements. Discuss the key***

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issues that CA Lalit should deliberate and guide his team members with respect to this engagement and the manner it differs from assurance engagements. Give your views on the applicability of SQC 1 to this engagement.

7. ***Brown Enterprises Limited has huge funds locked up in its trade receivables standing at around ₹ 100 crores as on 31st December, 2023. The management of the company wants to evaluate the validity of the trade receivables to ensure reliability of financial reporting at the year end. The accounts department has provided a list of trade receivables to the management containing about 1000 names, their balances and contact/communication details spread in different parts of the country. The company's management has requested CA Kamna to take up this assignment and prepare a report for management in accordance with professional standards. Despite not being statutory auditor of the company, she decides to accept the above engagement.***

   (a) By explaining the nature of engagement described above, discuss whether it was proper for her to accept such engagement.

   (b) While reporting, which precautions should be taken by her so that readers of the report do not misunderstand its scope?

8. ***You have been appointed to compile the financial statements of Kings & Company (a partnership firm) for tax purposes. During the course of your work, you discover that the inventory is grossly understated, and the company has failed to apply applicable standards. On pointing out the same, the partners of Kings & Company inform you that it is outside your scope since you are not conducting an audit and the said figures duly certified by the firm should be accepted. Comment.***

Answers to Test Your Understanding Questions

1. The described engagement is an agreed-upon procedures engagement. Following points have to be kept in mind for being included in the report: -

- A statement that the procedures performed were those agreed-upon with the recipient
- A statement that the engagement was performed in accordance with the Standard on Related Services applicable to agreed-upon procedures engagements
- Identification of the purpose for which the agreed-upon procedures were performed
- A listing of the specific procedures performed

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- A description of the auditor's factual findings including sufficient details of errors and exceptions found
- A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed
- A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported
- A statement that the report is restricted to those parties that have agreed to the procedures to be performed
- A statement that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole

2. In this instant case, amount of ₹ 100 lacs is reflected under the head "current assets" in trial balance. Since our client's claim has been repudiated and no appeal has been preferred, it is a loss for the client and should be dealt with accordingly. Therefore, amendments are required for the financial information not to be materially misstated.

If the practitioner becomes aware during the course of the engagement that amendments to the compiled financial information are required for the financial information not to be materially misstated or the compiled financial information is otherwise misleading, the practitioner shall propose the appropriate amendments to management.

If management declines or does not permit the practitioner to make the proposed amendments to the compiled financial information, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.

If withdrawal from the engagement is not possible, the practitioner shall determine the professional and legal responsibilities applicable in the circumstances.

Answers to Integrated Case Scenario

1. (b) **2.** (c) **3.** (b) **4.** (a) **5.** (c)

Hints/Answers to Theoretical Questions

1. Refer to Para 3.

2. Refer to Para 3.3.

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3. Refer to Para 1.

4. Refer to Para 3.9.

5. Refer to Para 3 and Para 3.5.

6. ***As per SRS 4410, Compilation engagement is an engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework and issues a report.***

Management may request a professional accountant in public practice to assist with the preparation and presentation of financial information of an entity. Financial information that is the subject of a compilation engagement may be required for various purposes including: -

- ***To comply with mandatory periodic financial reporting requirements established in law or regulation, if any or***
- ***For purposes unrelated to mandatory financial reporting under relevant law or regulation, including for example: -***
  - ✓ ***For management or those charged with governance, prepared on a basis appropriate for their particular purposes (such as preparation of financial information for internal use).***
  - ✓ ***For periodic financial reporting undertaken for external parties under a contract or other form of agreement (such as financial information provided to a funding body to support provision or continuation of a grant).***
  - ✓ ***For transactional purposes, for example to support a transaction involving changes to the entity's ownership or financing structure (such as for a merger or acquisition).***

"Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. It means that the practitioner gives an opinion about specific information due to which users of information are able to make confident decisions knowing well that chance of information being incorrect is diminished.

A compilation engagement is not an assurance engagement. A compilation engagement does not require the practitioner to verify the accuracy or completeness of the information provided by management for the compilation, or otherwise to gather

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evidence to express an audit opinion or a review conclusion on the preparation of the financial information.

Further, SQC 1 is applicable to all Engagement and Quality Control Standards. Since SRS 4410 is also one of Engagement and Quality Control Standards, SQC 1 applies to firms in respect of firm's compilation engagements too which is covered in Related Services.

7. (a) *The above situation involves an engagement to perform agreed-upon procedures. In such an engagement, the auditor is engaged by the client to issue a report of factual findings based on specified procedures performed on specified subject matter of specified elements, accounts or items of a financial statement.*

The management has requested CA Kamna to take up the assignment and prepare a report for management in accordance with professional standards. Such type of engagement and its reporting falls in purview of SRS 4400. The reference to auditor in SRS 4400 does not imply that a person performing related services need necessarily be the auditor of entity's financial statements. Hence, a person performing related services need not necessarily be auditor of entity's financial statements. Therefore, it was proper for CA Kamna to accept the above engagement.

(b) *While reporting, she should take following precautions so that readers of report do not misunderstand its scope: -*

- *A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed.*
- *A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported.*
- *A statement that the report is restricted to those parties that have agreed to the procedures to be performed.*
- *A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole.*

8. *As per SRS 4410, "Compilation Engagements", if the practitioner is unable to complete the engagement because management has failed to provide records, documents, explanations or other information, including significant judgments, as requested, the*

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practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.

If the practitioner becomes aware during the course of the engagement that:

(a) The compiled financial information does not adequately refer to or describe the applicable financial reporting framework

(b) Amendments to the compiled financial information are required for the financial information not to be materially misstated; or

(c) The compiled financial information is otherwise misleading the practitioner shall propose the appropriate amendments to management.

If management declines or does not permit the practitioner to make the proposed amendments to the compiled financial information, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.

If withdrawal from the engagement is not possible, the practitioner shall determine the professional and legal responsibilities applicable in the circumstances.

The practitioner shall obtain an acknowledgement from management or those charged with governance, as appropriate, that they have taken responsibility for the final version of the compiled financial information.

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CHAPTER 10

REVIEW OF FINANCIAL INFORMATION



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the meaning of review.
- Know about Standards on Review Engagements.
- Gain the Knowledge about SRE 2400 Engagements to Review Historical Financial Statements.
- Know about the importance of "Inquiry" and "Analytical Procedures" in a review engagement.
- Gain the Knowledge about SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity.
- Understand in detail about contents of review reports under SRE 2400 and SRE 2410 respectively.

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CHAPTER OVERVIEW

Review of Financial Information	Basic and Overview of SRE 2400-Engagements to Review Historical Financial Statements;
	Basic and Overview of SRE 2410-Review of Interim Financial Information Performed by the Independent Auditor of the Entity.

Madhulika, a CA final student, was part of an engagement team conducting "Review" of quarterly results of "Track Data Limited", a listed company. The audit firm, she was working with, was also statutory auditor of this company. It was a new assignment for her. She knew about mandatory review of quarterly financial results of listed companies by auditors in accordance with SEBI listing regulations.

She was trying to figure out the difference between scope of an audit and review. Why a "Review" has been mandated by the regulator? Does such an exercise involve carrying out of same procedures as in case of an audit? If no, which types of procedures are mainly performed in such an engagement?

Are such procedures limited to reconciling financial statements with underlying accounting records? Whether such an exercise involves performing some other necessary procedures too? Another pertinent issue troubling her related to obtaining of evidence. Whether, in a review, sufficient and appropriate evidence is gathered too? Are responsibilities of a professional accountant performing a review similar to one performing an audit? Basically, she wanted mist on very objective of a review exercise to be cleared.

Excited she was, to understand about reporting requirements, in case of a review engagement. If there was difference in scope of "audit" and "review", contents of a review report ought to be different. What happens if misstatements identified during course of reviewing quarterly results are not corrected by company management?

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Is it possible to issue a modified review report just as in case of an audit? What are modalities of the same? "Mandatory responsibilities of professional accountants for a review engagement must have been clinically described in Standards on Review Engagements" - She was seriously contemplating.

She was also considering possibilities of other usage of review of financial information. Besides meeting with mandatory legal and regulatory requirements, what could be other benefits of review engagements to different entities?

1. INTRODUCTION

What is REVIEW?

"Review" is a limited assurance engagement. Limited assurance is the level of assurance obtained where engagement risk is reduced to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for expressing a conclusion. The combination of nature, timing and extent of evidence gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the financial statements.

In simpler terms, limited assurance engagement provides lower level of assurance than audit. It involves fewer procedures and, gathers sufficient and appropriate evidence on basis of which *limited conclusions* can be drawn up. However, "review" is related to financial statements prepared on basis of historical financial information just like an audit.

1.1 Standards on Review Engagements

Standards on Review Engagements apply where "Review" of financial information is undertaken by the practitioner. Following Standards on review engagements have been issued in this regard:

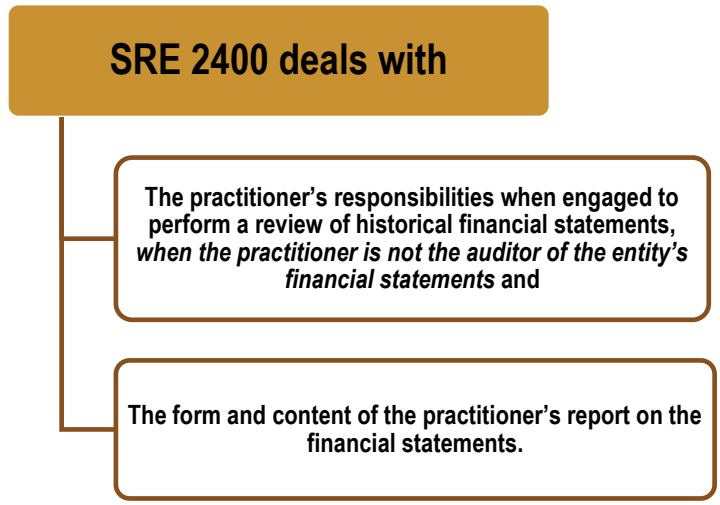
Standards on Review Engagements
• SRE 2400 Engagements to Review Historical Financial Statements
• SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity

It is worth remembering that Standards on Quality Control (SQCs) are to be applied for all services covered by Engagement Standards. Standards on review engagements are part of Engagement

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Standards. Therefore, quality control at the level of individual review engagements is premised on the basis that the firm is subject to SQC 1.

2. SRE 2400 ENGAGEMENTS TO REVIEW HISTORICAL FINANCIAL STATEMENTS



In a review of financial statements, the practitioner expresses a conclusion that is designed to enhance the degree of confidence of intended users regarding the preparation of an entity's financial statements in accordance with an applicable financial reporting framework. Such financial statements may have been prepared using general purpose framework or special purpose framework.

The practitioner's conclusion is based on the practitioner obtaining limited assurance. The practitioner's report includes a description of the nature of a review engagement as context for the readers of the report to be able to understand the conclusion.

The practitioner performs primarily *inquiry and analytical procedures* to obtain sufficient and appropriate evidence as the basis for a conclusion on the financial statements as a whole.

If the practitioner becomes aware of a matter that causes the practitioner to believe the financial statements may be materially misstated, he/she designs and performs additional procedures, as he/she considers necessary in the circumstances, to be able to conclude on the financial statements.

SRE 2400 deals with the practitioner's responsibilities performing a review of historical financial statements when the practitioner is not the auditor of the entity's financial statements.

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2.1 Objectives in a review of financial statements in accordance with SRE 2400

The practitioner's objectives in a review of financial statements in accordance with SRE 2400 are as under:

(a)	Obtain limited assurance, primarily by making an *inquiry* and performing *analytical procedures,* about whether the financial statements as a whole are free from material misstatement, thereby enabling the practitioner to express a conclusion on whether anything has come to his attention that causes him to believe the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework
(b)	Report on the financial statements as a whole and communicate, as required by this SRE.

In all cases when limited assurance cannot be obtained and a modified conclusion in the practitioner's report is insufficient in the circumstances, this SRE requires that the practitioner either to disclaim a conclusion in the report issued for the engagement or, where appropriate to withdraw from the engagement if withdrawal is possible under applicable law or regulations.

TEST YOUR UNDERSTANDING 1

Roma Limited has entered into a contract with Dorma Limited. There is a condition in the contract by virtue of which Roma Limited is required to get its financial statements reviewed for a year on a quarterly basis in accordance with the financial reporting provisions of the contract. Can Roma Limited get its financial statements reviewed from a professional accountant in practice?

2.2 Compliance with Ethical Requirements and Engagement Level Quality Control

The practitioner shall comply with relevant ethical requirements, including those pertaining to independence and the engagement partner is responsible for overall quality of each review engagement.

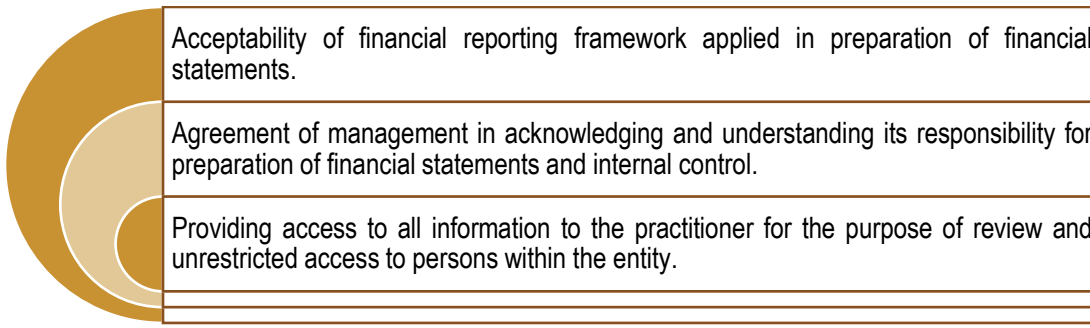
Factors affecting Acceptance and Continuance of Client Relationships and Review Engagements

Unless required by law or regulation, the practitioner shall not accept a review engagement if:	
(a)	**The practitioner is not satisfied:**

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(i) That there is a rational purpose for the engagement. Assurance engagements may only be accepted when the engagement exhibits certain characteristics that are conducive to achieving the practitioner's objectives specified for the engagement. It may be unlikely that there is a rational purpose for the engagement if, for example, there is a significant limitation on the scope of work or the practitioner suspects association of the practitioner's name with the financial statements in an inappropriate manner. Similarly, when the engagement is intended to meet compliance requirements of relevant law or regulation and such law or regulation requires the financial statements to be audited, there is no rational purpose for such a review engagement.	(ii) That a review engagement would be appropriate in the circumstances. When the practitioner's preliminary understanding of the engagement circumstances indicates that accepting a review engagement would not be appropriate, the practitioner may consider recommending that another type of engagement be undertaken. Depending on the circumstances, the practitioner may, for example, believe that performance of an audit engagement would be more appropriate than a review. In other cases, if the engagement circumstances preclude the performance of an assurance engagement, the practitioner may recommend a compilation engagement, or other accounting services engagement, as appropriate.
(b) The practitioner has reason to believe that relevant ethical requirements, including independence, will not be satisfied.	
(c) The practitioner's preliminary understanding of the engagement circumstances indicates that information needed to perform the review engagement is likely to be unavailable or unreliable.	
(d) The practitioner has cause to doubt management's integrity such that it is likely to affect proper performance of the review or	
(e) Management or those charged with governance impose a limitation on the scope of the practitioner's work in the terms of a proposed review engagement such that the practitioner believes that the limitation will result in the practitioner disclaiming a conclusion on the financial statements.	

2.3 Preconditions for Accepting a Review Engagement



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Prior to accepting a review engagement, the practitioner shall: -

(a) Determine whether the financial reporting framework applied in the preparation of the financial statements is acceptable including, in the case of special purpose financial statements, obtaining an understanding of the purpose for which the financial statements are prepared and of the intended users, and		
(b) Obtain the agreement of management that it acknowledges and understands its responsibilities: (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation. (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (iii) To provide the practitioner with: -		
a. Access to all information of which management is aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;	b. Additional information that the practitioner may request from management for the purpose of the review; and	c. Unrestricted access to persons within the entity from whom the practitioner determines it necessary to obtain evidence.

If the practitioner is not satisfied as to any of the matters set out above as preconditions for accepting a review engagement, the practitioner shall discuss the matter with the management or those charged with governance.

If changes cannot be made to satisfy the practitioner as to those matters, the practitioner shall not accept the proposed engagement unless required by law or regulation to do so. However, an engagement conducted under such circumstances does not comply with this SRE. Accordingly, the practitioner shall not include any reference within the practitioner's report to the review having been conducted in accordance with this SRE.

If it is discovered after the engagement has been accepted that the practitioner is not satisfied as to any of the above preconditions, the practitioner shall discuss the matter with the management or those charged with governance and shall determine:

(a) Whether the matter can be resolved	(b) Whether it is appropriate to continue with the engagement and	(c) Whether and, if so, how to communicate the matter in the practitioner's report.

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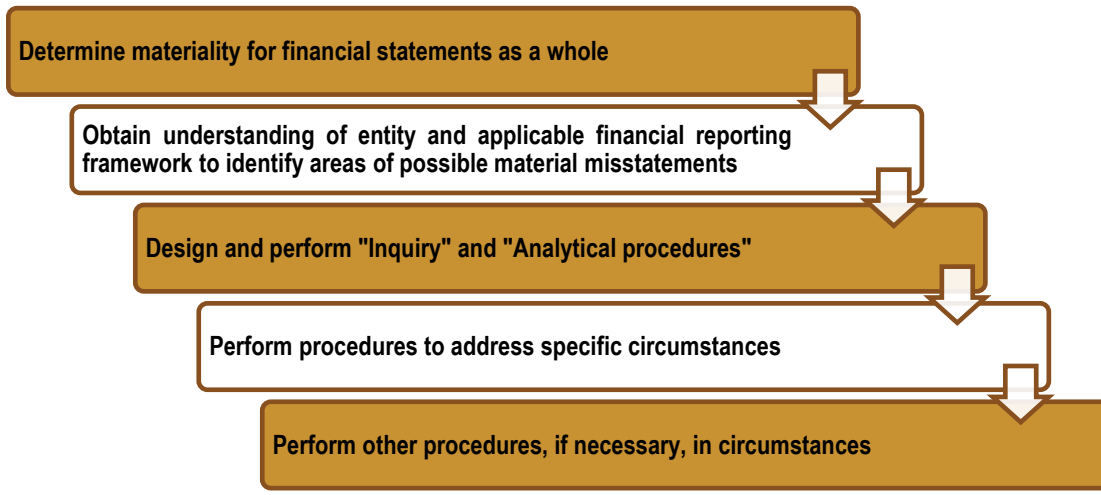
2.4 Agreeing to the Terms of Engagement

The practitioner shall agree to the terms of the engagement with the management or those charged with governance, as appropriate, prior to performing the engagement. The agreed terms of engagement shall be recorded in an engagement letter or other suitable form of written agreement. On recurring review engagements, the practitioner shall evaluate whether circumstances, including changes in the engagement acceptance considerations, require the terms of engagement to be revised and whether there is a need to remind management or those charged with governance, as appropriate, of the existing terms of engagement.

The practitioner shall not agree to a change in the terms of the engagement where there is no reasonable justification for doing so. If, prior to completing the review engagement, the practitioner is requested to change the engagement to an engagement for which no assurance is obtained, the practitioner shall determine whether there is reasonable justification for doing so.

If the terms of engagement are changed during the course of the engagement, the practitioner and the management or those charged with governance, as appropriate, shall agree on and record the new terms of engagement in an engagement letter or any other suitable form of written agreement.

Overview of performing the review engagement after its acceptance in accordance with SRE2400



(i) Materiality in a Review of Financial Statements

The practitioner shall determine materiality for the financial statements as a whole and apply this materiality in designing the procedures and in evaluating the results obtained from those procedures. The practitioner's judgment about what is material in relation to the financial statements as a whole

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is the same regardless of the level of assurance obtained by a practitioner as the basis for expressing the conclusion on the financial statements.

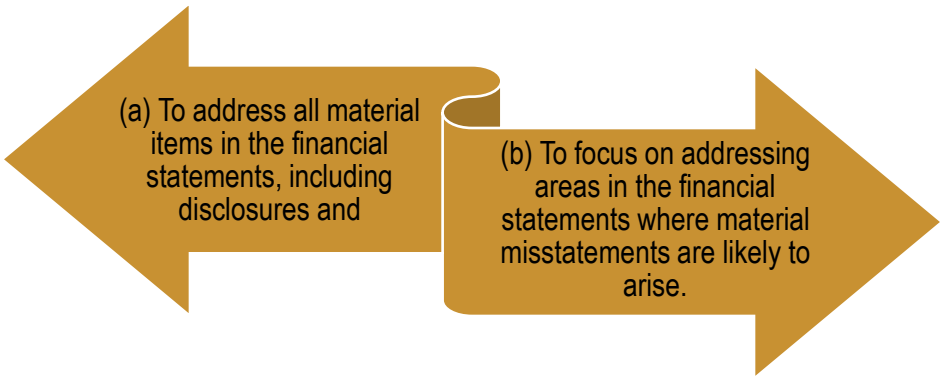
The practitioner shall revise materiality for the financial statements as a whole in the event of becoming aware of any information during the review that would have caused the practitioner to have determined a different amount initially.

(ii) Obtaining Understanding of the Entity

The practitioner shall obtain an understanding of the entity and its environment and the applicable financial reporting framework to identify areas in the financial statements where material misstatements are likely to arise and thereby provide a basis for designing procedures to address those areas.

(iii) Designing and Performing Procedures

In obtaining sufficient appropriate evidence as the basis for a conclusion on the financial statements as a whole, the practitioner shall design and perform inquiry and analytical procedures: -



The requirements relating to designing and performing of inquiry and analytical procedures, and procedures addressing specific circumstances, are designed to enable the practitioner to achieve the objectives of this SRE. The circumstances of review engagements vary widely and, accordingly, there may be circumstances where the practitioner may consider it effective or efficient to design and perform other procedures.

For example, if in the course of obtaining an understanding of the entity, the practitioner becomes aware of a significant contract the practitioner may choose to read the contract.

The fact that the practitioner may deem it necessary to perform other procedures does not alter the practitioner's objective of obtaining limited assurance in relation to the financial statements as a whole.

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The practitioner may consider, reviewing the accounting records with a view to identifying significant or unusual transactions that may require specific attention in the review.

(a) **Inquiry:** In a review, inquiry includes seeking information from management and other persons within the entity, as the practitioner considers appropriate in the engagement circumstances.

Inquiries may include matters such as those relating to making of accounting estimates, identification of related parties, about significant, complex or unusual transactions, existence of any actual, suspected or alleged fraud, events occurring between the date of the financial statements and practitioner's report, basis for management's assessment of the entity's ability to continue as a going concern, events or conditions that appear to cast doubt on the entity's ability to continue as a going concern, material commitments, contractual obligations or contingencies that have affected or may affect the entity's financial statements including disclosures and material non-monetary transactions or transactions for no consideration in the financial reporting period under consideration.

The practitioner may also extend Inquiries to obtain non-financial data if appropriate. Evaluating the responses provided by the management is integral to the inquiry process.

Depending on the engagement circumstances, inquiries may also include inquiries about:

- Actions taken at meetings of owners, those charged with governance and committees thereof, and proceedings at other meetings, if any, that affect the information and disclosures contained in the financial statements.
- Communications the entity has received, or expects to receive or obtain, from regulatory agencies.
- Matters arising in the course of applying other procedures.

When performing further inquiries in relation to identified inconsistencies, the practitioner considers the reasonableness and consistency of management's responses in light of the results obtained from other procedures, and the practitioner's knowledge and understanding of the entity and the industry in which it operates.

(b) **Analytical procedures:** In designing analytical procedures, the practitioner shall consider whether the data from the entity's accounting system and accounting records are adequate for the purpose of performing the analytical procedures.

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In a review, the practitioner mainly focuses upon inquiry and analytical procedures for obtaining sufficient appropriate evidence as the basis for conclusion on financial statements as a whole.

Why "Inquiry" and "Analytical procedures" are important in Review?

Evidence obtained through inquiry is often the principal source of evidence about management intent. However, information available to support management's intent may be limited. In that case, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry. Application of professional skepticism in evaluating responses provided by management is important to enable the practitioner to evaluate whether there are any matters that would cause the practitioner to believe the financial statements may be materially misstated.

Performing inquiry procedures also assists the practitioner in obtaining or updating the practitioner's understanding of the entity and its environment, to be able to identify areas where material misstatements are likely to arise in the financial statements.

In a review of financial statements, performing analytical procedures assists the practitioner in:

- Obtaining or updating the practitioner's understanding of the entity and its environment, including to be able to identify areas where material misstatements are likely to arise in the financial statements.
- Identifying inconsistencies or variances from expected trends, values or norms in the financial statements such as the level of congruence of the financial statements with key data, including key performance indicators.
- Providing corroborative evidence in relation to other inquiries or analytical procedures already performed.
- Serving as additional procedures when the practitioner becomes aware of matters that cause the practitioner to believe that the financial statements may be materially misstated.

An example of such an additional procedure is a comparative analysis of monthly revenue and cost figures across profit centers, branches or other components of the entity, to provide evidence about financial information contained in line items or disclosures made in the financial statements.

Various methods may be used to perform analytical procedures ranging from performing simple comparisons to performing complex analysis using statistical techniques. The practitioner may, for

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example, apply analytical procedures to evaluate the financial information underlying the financial statements and assessment of results for consistency with expected values. Expectations may be developed by the practitioner on information obtained from relevant sources like information regarding the industry in which entity operates.

(iv) Procedures to Address Specific Circumstances

- ***Related parties:*** During the review, the practitioner shall remain alert for arrangements or information that may indicate the existence of related party relationships or transactions that the management has not previously identified or disclosed to the practitioner. If the practitioner identifies significant transactions outside the entity's normal course of business during the course of review, the practitioner shall inquire with the management about the nature of those transactions, possible involvement of related parties and the business rationale (or lack thereof) of those transactions.

- ***Fraud and non-compliance with laws or regulations:*** When there is an indication that fraud or non-compliance with laws or regulations, or suspected fraud or non-compliance with laws or regulations, has occurred in the entity, the practitioner shall communicate that matter to the appropriate level of senior management or those charged with governance as appropriate and request management's assessment of the effects, if any, on the financial statements.

  The practitioner has to consider the effect, if any, of management's assessment of the effects of fraud or non-compliance with laws or regulations communicated to him on his conclusion on the financial statements and on his report and determine whether there is a responsibility to report the occurrence or suspicion of fraud or illegal acts to a party outside the entity.

- ***Going concern:*** A review of financial statements includes consideration of the entity's ability to continue as a going concern. If, during the performance of the review, the practitioner becomes aware of events or conditions that may cast significant doubt about the entity's ability to continue as a going concern, the practitioner shall:

  (a) Inquire of management about plans for future actions affecting the entity's ability to continue as a going concern and about the feasibility of those plans, and also whether management believes that the outcome of those plans will improve the situation regarding the entity's ability to continue as a going concern.

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(b) Evaluate the results of those inquiries, to consider whether management's responses provide a sufficient basis to: -

(i) Continue to present the financial statements on the going concern basis if the applicable financial reporting framework includes the assumption of an entity's continuance as a going concern; or

(ii) Conclude whether the financial statements are materially misstated, or are otherwise misleading regarding the entity's ability to continue as a going concern; and

(c) Consider management's responses in light of all relevant information of which the practitioner is aware as a result of the review.

- **Use of work performed by others:** In performing the review, it may be necessary for the practitioner to use work performed by other practitioners, or the work of an individual or organization possessing expertise in a field other than accounting or assurance. If the practitioner uses work performed by another practitioner or an expert in the course of performing the review, the practitioner shall take appropriate steps to be satisfied that the work performed is adequate for the practitioner's purposes.

  When the practitioner is engaged to review the financial statements of a group of entities, the planned nature, timing and extent of the procedures for the review are directed at achieving the practitioner's objectives for the review engagement in accordance with this Standard but in the context of the group financial statements.

(v) Additional procedures when the practitioner becomes aware that the financial statements may be materially misstated:

If the practitioner becomes aware of matters that causes the practitioner to believe that the financial statements may be materially misstated, the practitioner shall design and perform additional procedures sufficient to enable the practitioner to:

(a) Conclude that the matter(s) is not likely to cause the financial statements as a whole to be materially misstated or

(b) Determine that the matter(s) causes the financial statements as a whole to be materially misstated.

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Additional procedures are required under this SRE if the practitioner becomes aware of a matter that causes the practitioner to believe the financial statements may be materially misstated. The practitioner's response in undertaking additional procedures with respect to an item the practitioner has cause to believe may be materially misstated in the financial statements will vary, depending on the circumstances, and is a matter for the practitioner's professional judgment.

Additional procedures focus on obtaining sufficient appropriate evidence to enable the practitioner to form a conclusion on matters that the practitioner believes may cause the financial statements to be materially misstated. The procedures may be:
• Additional inquiry or analytical procedures, for example, being performed in greater detail or being focused on the affected items (i.e. amounts or disclosures concerning the affected accounts or transactions as reflected in the financial statements); or
• Other types of procedures, for example, substantive test of details or external confirmations.

Example explaining when additional procedures may be necessary in Review

In course of performing inquiry and analytical procedures for review, analysis of accounts receivable shows a material amount of past due accounts receivable, for which there is no allowance for bad or doubtful debts. This causes the practitioner to believe that the accounts receivable balance in the financial statements may be materially misstated. The practitioner then inquire of management whether there are uncollectible accounts receivable that would need to be shown as being impaired.

Depending on management's response, the practitioner's evaluation of the response may:

(a) Enable the practitioner to conclude that the accounts receivable balance is not likely to be materially misstated. In that case, no further procedures are required.

(b) Enable the practitioner to determine that the matter causes the financial statements to be materially misstated. No further procedures are required, and the practitioner would form the conclusion that the financial statements as a whole are materially misstated.

(c) Lead the practitioner to continue to believe that the accounts receivable balance is likely to be materially misstated, while not providing sufficient appropriate evidence for the practitioner to determine that they are in fact misstated.

In that case, the practitioner is required to perform additional procedures, for example, requesting from management an analysis of amounts received for those accounts after the balance sheet date to identify uncollectible accounts receivable.

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The evaluation of the results of the additional procedures may enable the practitioner to get to (a) or (b) above.

If not, the practitioner is required to: -

(i) Continue performing additional procedures until the practitioner reaches either (a) or (b) above or

(ii) If the practitioner is not able to either conclude that the matter is not likely to cause the financial statements as a whole to be materially misstated or to determine that the matter does cause the financial statements as a whole to be materially misstated, then a scope limitation exists, and the practitioner is not able to form an unmodified conclusion on the financial statements.

If the practitioner becomes aware of events occurring between the date of the financial statements and the date of the practitioner's report that require adjustment of, or disclosure in, the financial statements, the practitioner shall request management to correct those misstatements.

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

(a) Discuss the matter with management or those charged with governance, as appropriate

(b) Determine whether the financial statements need amendment and

(c) If so, inquire how management intends to address the matter in the financial statements.

If management does not amend the financial statements in circumstances where the practitioner believes they need to be amended, and the practitioner's report has already been provided to the entity, the practitioner shall notify management and those charged with governance not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the practitioner shall take appropriate action k to prevent reliance on the practitioner's report.

(vi) Written Representations

Written representations are an important source of evidence in a review engagement. If management modifies or does not provide the requested written representations, it may alert the practitioner to the possibility that one or more significant issues may exist. Further, a request for written, rather

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than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

The practitioner shall request management to provide a written representation that management has fulfilled its responsibilities described in the agreed terms of engagement. The written representation shall include that: -
(a) Management has fulfilled its responsibility for the preparation of financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, and has provided the practitioner with all relevant information and access to information as agreed in the terms of the engagement; and
(b) All transactions have been recorded and are reflected in the financial statements.

If law or regulation requires management to make written public statements about its responsibilities, and the practitioner determines that such statements provide some or all of the representations required above, the relevant matters covered by such statements need not be included in the written representation.

In addition to the written representations required under this SRE, the practitioner may consider it necessary to request other written representations about the financial statements. These may be needed, for example, to complete the practitioner's evidence with respect to certain items or disclosures reflected in the financial statements where the practitioner considers such representations to be important in forming a conclusion on the financial statements on either a modified or unmodified basis.

The practitioner shall also request management's written representations that management has disclosed to the practitioner: -
(a) The identity of the entity's related parties and all the related party relationships and transactions of which management is aware;
(b) Significant facts relating to any frauds or suspected frauds known to management that may have affected the entity;
(c) Known actual or possible non-compliance with laws and regulations for which the effects of non-compliance affect the entity's financial statements;
(d) All information relevant to use of the going concern assumption in the financial statements;

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(e)	That all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure, have been adjusted or disclosed;
(f)	Material commitments, contractual obligations or contingencies that have affected or may affect the entity's financial statements, including disclosures;
(g)	Material non-monetary transactions or transactions for no consideration undertaken by the entity in the financial reporting period under consideration.

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

(a) Discuss the matter with management and those charged with governance, as appropriate;

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

(c) Take appropriate actions, including determining the possible effect on the conclusion in the practitioner's report in accordance with this SRE.

The practitioner shall disclaim a conclusion on the financial statements, or withdraw from the engagement if withdrawal is possible under applicable law or regulation, as appropriate, if: -

(a) The practitioner concludes that there is sufficient doubt about the integrity of management such that the written representations are not reliable or

(b) Management does not provide the required representations in respect of its responsibilities for preparation of financial statements and recording of all transactions in financial statements.

(vii) Evaluating evidence obtained from the procedures performed

The practitioner shall evaluate whether sufficient appropriate evidence has been obtained from the procedures performed and, if not, the practitioner shall perform other procedures judged by the practitioner to be necessary in the circumstances to be able to form a conclusion on the financial statements.

In some circumstances, the practitioner may not have obtained the evidence that the practitioner had expected to obtain through the design of primarily inquiry and analytical procedures and procedures addressing specific circumstances.

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In these circumstances, the practitioner considers that the evidence obtained from the procedures performed is not sufficient and appropriate to be able to form a conclusion on the financial statements.

The practitioner may:
• Extend the work performed or
• Perform other procedures judged by the practitioner to be necessary in the circumstances.

Where neither of these is practicable in the circumstances, the practitioner will not be able to obtain sufficient appropriate evidence to be able to form a conclusion and is required by this SRE to determine the effect on the practitioner's report, or on the practitioner's ability to complete the engagement, for example, if a member of management is unavailable at the time of the review to respond to the practitioner's inquiries on significant matters.

If the practitioner is not able to obtain sufficient appropriate evidence to form a conclusion, the practitioner shall discuss with management and those charged with governance, as appropriate, the effects such limitations have on the scope of the review.

Inability to perform a specific procedure does not constitute a limitation on the scope of the review if the practitioner is able to obtain sufficient appropriate evidence by performing other procedures. Limitations on the scope of the review imposed by management may have other implications for the review, such as for the practitioner's consideration of areas where the financial statements are likely to be materially misstated, and engagement continuance.

(viii) Forming the practitioner's conclusion on the financial statements

In forming conclusion, the practitioner shall also consider the impact of: -

(a) Uncorrected misstatements identified during the review, and in the previous year's review of the entity's financial statements, on the financial statements as a whole

(b) Qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

If the financial statements are prepared using a fair presentation framework, the practitioner's consideration shall also include: -
(a) The overall presentation, structure and content of the financial statements in accordance with the applicable framework and

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(b) Whether the financial statements, including the related notes, appear to represent the underlying transactions and events in a manner that achieves fair presentation or gives a true and fair view, as appropriate, in the context of the financial statements as a whole.

The practitioner's conclusion on the financial statements, whether unmodified or modified, shall be expressed in the appropriate form in the context of the financial reporting framework applied in the financial statements.

Unmodified Conclusion: The practitioner shall express an unmodified conclusion in the practitioner's report on the financial statements as a whole when the practitioner has obtained limited assurance to be able to conclude that nothing has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework.

When the practitioner expresses an unmodified conclusion, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate: -

(a) "Based on our review, nothing has come to our attention that causes us to believe that the financial statements do not give a true and fair view (or do not present fairly, in all material respects), in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework); or

(b) "Based on our review, nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).

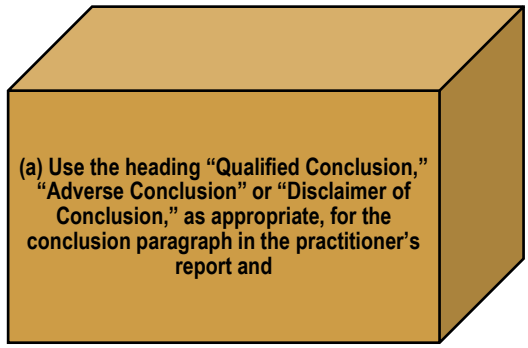
Modified Conclusion: The practitioner shall express a modified conclusion in the practitioner's report on the financial statements as a whole when:

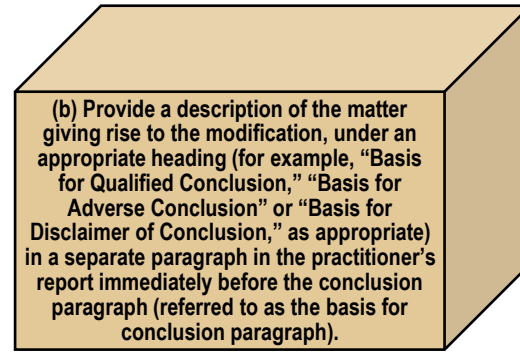
(a) The practitioner determines, based on the procedures performed and the evidence obtained, that the financial statements are materially misstated or

(b) The practitioner is unable to obtain sufficient and appropriate evidence in relation to one or more items in the financial statements that are material in relation to the financial statements as a whole.

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When the practitioner modifies the conclusion expressed on the financial statements, the practitioner shall:





Financial statements are materially misstated.

If the practitioner determines that the financial statements are materially misstated, the practitioner shall express	
(a) A qualified conclusion, when the practitioner concludes that the effects of the matter(s) giving rise to the modification are material, but not pervasive to the financial statements; or	(b) An adverse conclusion, when the effects of the matter(s) giving rise to the modification are both material and pervasive to the financial statements.

When the practitioner expresses a qualified conclusion on the financial statements because of a material misstatement, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate: -

(a) *"Based on our review, except for the effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements do not give a true and fair view (or do not present fairly, in all material respects), in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework) or*

(b) *"Based on our review, except for the effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).*

When the practitioner expresses **an adverse conclusion** on the financial statements, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate:

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(a) **"Based on our review, due to the significance of the matter(s) described in the Basis for Adverse Conclusion paragraph, the financial statements do not give a true and fair view (or do not present fairly, in all material respects), in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework); or**

(b) **"Based on our review, due to the significance of the matter(s) described in the Basis for Adverse Conclusion paragraph, the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).**

In the basis for conclusion paragraph, in relation to material misstatements that give rise to either a qualified conclusion or an adverse conclusion, the practitioner shall: -
(a) Describe and quantify the financial effects of the misstatement if the material misstatement relates to specific amounts in the financial statements (including quantitative disclosures), unless impracticable, in which case the practitioner shall so state;
(b) Explain how disclosures are misstated if the material misstatement relates to narrative disclosures; or
(c) Describe the nature of omitted information if the material misstatement relates to the non-disclosure of information required to be disclosed. Unless prohibited by law or regulation, the practitioner shall include the omitted disclosures where practicable to do so.
Narrative accounting disclosures are an integral part of the corporate financial reporting package. They are deemed to provide a view of the company "through the eyes of management". The narratives represent management's construal of corporate events and are largely discretionary.

Inability to obtain sufficient and appropriate evidence:

If the practitioner is unable to form a conclusion on the financial statements due to the inability to obtain sufficient appropriate and evidence, the practitioner shall:

(a)	Express a qualified conclusion if the practitioner concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive or
(b)	Disclaim a conclusion if the practitioner concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

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The practitioner shall withdraw from the engagement if the following conditions are present		
(a) Due to a limitation on the scope of the review imposed by management after the practitioner has accepted the engagement, the practitioner is unable to obtain sufficient appropriate and evidence to form a conclusion on the financial statements;	(b) The practitioner has determined that the possible effects on the financial statements of undetected misstatements are material and pervasive; and	(c) Withdrawal is possible under applicable law or regulation.

When the practitioner expresses a qualified conclusion on the financial statements due to inability to obtain sufficient and appropriate evidence, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate:

(a) *"Based on our review, except for the possible effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements do not give a true and fair view (or do not present fairly, in all material respects) in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework); or*

(b) *"Based on our review, except for the possible effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).*

When disclaiming a conclusion on the financial statements the practitioner shall state in the conclusion paragraph that:	
(a)	Due to the significance of the matter(s) described in the Basis for Disclaimer of Conclusion paragraph, the practitioner is unable to obtain sufficient appropriate evidence to form a conclusion on the financial statements; and
(b)	Accordingly, the practitioner does not express a conclusion on the financial statements.

In the basis for conclusion paragraph, in relation to either the qualified conclusion due to inability of obtaining sufficient and appropriate evidence or when the practitioner disclaims a conclusion, the practitioner shall include the reason(s) for the inability to obtain sufficient and appropriate evidence.

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(ix) The Practitioner's Report

The practitioner's report for the review engagement shall be in writing and shall contain the following elements: -

(a) A title, which shall clearly indicate that it is the report of an independent practitioner for a review engagement;

(b) The addressee(s), as required by the circumstances of the engagement;

(c) **An introductory paragraph that:**

(1) Identifies the financial statements reviewed, including identification of the title of each of the statements contained in the set of financial statements and the date and period covered by each financial statement;

(2) Refers to the summary of significant accounting policies and other explanatory information; and

(3) States that the financial statements have been reviewed;

(d) **A description of the responsibility of management for the preparation of the financial statements, including an explanation that management is responsible for:**

(1) Their preparation in accordance with the applicable financial reporting framework including, where relevant, their fair presentation;

(2) Such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;

(e) **If the financial statements are special purpose financial statements:**

(1) A description of the purpose for which the financial statements are prepared and, if necessary, the intended users, or reference to a note in the special purpose financial statements that contains that information; and

(2) If management has a choice of financial reporting frameworks in the preparation of such financial statements, a reference within the explanation of management's responsibility for the financial statements to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances;

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(f) A description of the practitioner's responsibility to express a conclusion on the financial statements including reference to this SRE and, where relevant, applicable law or regulation;

(g) **A description of a review of financial statements and its limitations, and the following statements:**

(1) A review engagement under this SRE is a limited assurance engagement;

(2) The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained; and

(3) The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Standards on Auditing (SAs), and, accordingly, the practitioner does not express an audit opinion on the financial statements;

(h) **A paragraph under the heading "Conclusion" that contains:**

(1) The practitioner's conclusion on the financial statements as a whole as appropriate; and

(2) A reference to the applicable financial reporting framework used to prepare the financial statements;

(i) **When the practitioner's conclusion on the financial statements is modified:**

(1) A paragraph under the appropriate heading that contains the practitioner's modified conclusion as appropriate; and

(2) A paragraph, under an appropriate heading, that provides a description of the matter(s) giving rise to the modification;

(j) A reference to the practitioner's obligation under this SRE to comply with relevant ethical requirements;

(k) **The date of the practitioner's report:** The practitioner shall date the report no earlier than the date on which the practitioner has obtained sufficient appropriate evidence as the basis for the practitioner's conclusion on the financial statements, including being satisfied that: -

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(1) All the statements that comprise the financial statements under the applicable financial reporting framework, including the related notes where applicable, have been prepared; and

(2) Those with the recognized authority have asserted that they have taken responsibility for those financial statements;

(l) The practitioner's signature; and

(m) The place of signature.

2.5 Emphasis of Matter and Other Matter Paragraphs in the Practitioner's Report

The practitioner may consider it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the practitioner's judgment, is of such importance that it is fundamental to users' understanding of the financial statements. In such cases, the practitioner shall include an Emphasis of Matter paragraph in the practitioner's report, provided the practitioner has obtained sufficient appropriate evidence to conclude that the matter is not likely to be materially misstated as presented in the financial statements. Such paragraph shall refer only to the information presented or disclosed in the financial statements.

The practitioner shall include an Emphasis of Matter paragraph immediately after the paragraph that contains the practitioner's conclusion on the financial statements under the heading "Emphasis of Matter," or other appropriate heading.

If the practitioner considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the practitioner's judgment, is relevant to users' understanding of the review, the practitioner's responsibilities or the practitioner's report and this is not prohibited by law or regulation, the practitioner shall do so in a paragraph in the practitioner's report with the heading "Other Matter" or other appropriate heading.

2.6 Other Reporting Responsibilities

A practitioner may be requested to address other reporting responsibilities in the practitioner's report on the financial statements that are in addition to the practitioner's responsibilities under this SRE to report on the financial statements. In such situations, those other reporting responsibilities shall be addressed by the practitioner in a separate section in the practitioner's report headed "Report on Other Legal and Regulatory Requirements," or otherwise as appropriate to the context of the section, following the section of the report headed "Report on the Financial Statements."

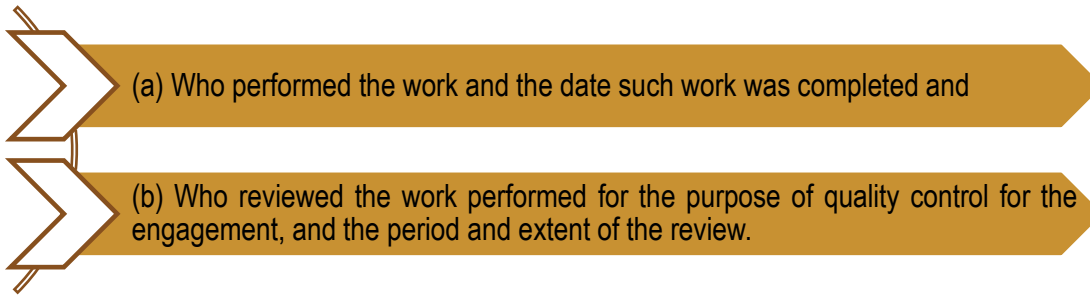
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2.7 Documentation

The preparation of documentation for the review provides evidence that the review was performed in accordance with this SRE along with legal and regulatory requirements where relevant and a sufficient and appropriate record of the basis for the practitioner's report.

The practitioner shall document the following aspects of the engagement in a timely manner, sufficient to enable an experienced practitioner, having no previous connection with the engagement, to understand:	
(a)	The nature, timing, and extent of the procedures performed to comply with this SRE and applicable legal and regulatory requirements;
(b)	Results obtained from the procedures, and the practitioner's conclusions formed on the basis of those results; and
(c)	Significant matters arising during the engagement, the practitioner's conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

While documenting the nature, timing and extent of procedures performed as required in this SRE, the practitioner shall record:



The practitioner shall also document discussions with the management, those charged with governance, and others as relevant to the performance of the review of significant matters arising during the engagement, including the nature of those matters.

If, in the course of the engagement, the practitioner identified information that is inconsistent with the practitioner's findings regarding significant matters affecting the financial statements, the practitioner shall document how the inconsistency was addressed.

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2.8 Audit Vs. Review

An audit engagement has many similarities with a review engagement. However, there are certain important areas of distinction relating to the nature of engagement, its performance, objective and reporting highlighted under: -

Overview of distinctive areas between Audit and Review

Audit	*Review*
Audit is a type of reasonable assurance engagement providing reasonable level of assurance.	Review is a type of limited assurance engagement providing a lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures including tests of controls and substantive procedures.	It performs fewer procedures primarily focusing on inquiry and analytical procedures.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It draws limited conclusions on the basis of sufficient appropriate evidence.
It provides an assurance opinion. The language of assurance opinion is positively worded.	It provides an assurance conclusion. The language of assurance conclusion is negatively worded.

TEST YOUR UNDERSTANDING 2

You are conducting a review of the financial statements of a company. It is gathered upon inquiry that there is a possibility of material misstatements in the financial statements. Discuss how you would proceed further in the matter under SRE 2400.

3. SRE 2410 REVIEW OF INTERIM FINANCIAL INFORMATION PERFORMED BY THE INDEPENDENT AUDITOR OF THE ENTITY

SRE 2410 deals with the auditor's professional responsibilities when the auditor undertakes an engagement to review the interim financial information of an audit client and on the form and content of the report. In other words, SRE 2410 applies when review of interim financial information is performed by the independent auditor of the financial statements of the entity.

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What is Interim Financial Information?

Interim financial information is financial information that is prepared and presented in accordance with an applicable financial reporting framework and comprises either a complete or a condensed set of financial statements *for a period that is shorter than the entity's financial year.* For example, interim financial information may relate to financial statements of a quarter of the financial year.

3.1 Objective of an Engagement to Review Interim Financial Information in Accordance with SRE 2410

The objective of an engagement to review interim financial information is to enable the auditor to express a conclusion whether, on the basis of the review, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with an applicable financial reporting framework. The auditor makes inquiries and performs analytical and other review procedures in order to reduce to a moderate level risk of expressing an inappropriate conclusion when the interim financial information is materially misstated.

The objective of a review of interim financial information differs significantly from that of an audit conducted in accordance with Standards on Auditing (SAs). A review of interim financial information does not provide a basis for expressing an opinion on whether the financial information gives a true and fair view, or is presented fairly, in all material respects, in accordance with an applicable financial reporting framework.

A review, in contrast to an audit, is not designed to obtain reasonable assurance that the interim financial information is free from material misstatement. A review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review may bring significant matters affecting the interim financial information to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

SRE 2410 applies when review of interim financial information is performed by the independent auditor of the financial statements of the entity.

3.2 Agreeing the Terms of the Engagement

The auditor and the client should agree on the terms of the engagement. The agreed terms of the engagement are ordinarily recorded in an engagement letter. Such communication helps to avoid misunderstandings regarding the nature of the engagement and, in particular, the objective and

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scope of the review, management's responsibilities, the extent of the auditor's responsibilities, the assurance obtained, and the nature and form of the report.

3.3 Understanding the Entity and its Environment including its Internal Control

The auditor should have an understanding of the entity and its environment, including its internal control, as it relates to the preparation of both annual and interim financial information, sufficient to plan and conduct the engagement so as to be able to:

(a) Identify the types of potential material misstatement and consider the likelihood of their occurrence and

(b) Select the inquiries, analytical and other review procedures that will provide the auditor with a basis for reporting whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.

The auditor who has audited the entity's financial statements for one or more annual periods has obtained an understanding of the entity and its environment, including its internal control, as it relates to the preparation of annual financial information that was sufficient to conduct the audit.

In planning a review of interim financial information, the auditor updates this understanding. The auditor also obtains a sufficient understanding of internal control as it relates to the preparation of interim financial information as it may differ from internal control as it relates to annual financial information.

Some of the procedures performed by the auditor to update the understanding of the entity and its environment, including its internal control, ordinarily include the following:

- Reading the documentation, to the extent necessary, of the preceding year's audit and reviews of prior interim period(s) of the current year and corresponding interim period(s) of the prior year, to enable the auditor to identify matters that may affect the current-period interim financial information.
- Considering any significant risks, including the risk of management override of controls, that were identified in the audit of the prior year's financial statements.
- Reading the most recent annual and comparable prior period interim financial information.

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- Considering materiality with reference to the applicable financial reporting framework as it relates to interim financial information to assist in determining the nature and extent of the procedures to be performed and evaluating the effect of misstatements.
- Considering the nature of any corrected material misstatements and any identified uncorrected immaterial misstatements in the prior year's financial statements.
- Considering significant financial accounting and reporting matters that may be of continuing significance such as material weaknesses in internal control.
- Considering the results of any audit procedures performed with respect to the current year's financial statements.
- Considering the results of any internal audit performed and the subsequent actions taken by the management.
- Inquiring of management about the results of management's assessment of the risk that the interim financial information may be materially misstated as a result of fraud.
- Inquiring of management about the effect of changes in the entity's business activities.
- Inquiring of management about any significant changes in internal control and the potential effect of any such changes on the preparation of interim financial information.
- Inquiring of management of the process by which the interim financial information has been prepared and the reliability of the underlying accounting records to which the interim financial information is agreed or reconciled.

In order to plan and conduct a review of interim financial information, *a recently appointed auditor, who has not yet performed an audit of the annual financial statements in accordance with SAs,* should obtain an understanding of the entity and its environment, including of its internal control, as it relates to the preparation of both annual and interim financial information.

Besides, the auditor determines the nature of the review procedures, if any, to be performed for components and, where applicable, communicates these matters to other auditors involved in the review.

3.4 Inquiries, Analytical and other Review procedures

The auditor should make inquiries, primarily of persons responsible for financial and accounting matters, and perform analytical and other review procedures to enable the auditor to conclude whether, on the basis of the procedures performed, anything has come to the auditor's attention that

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causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.

A review ordinarily does not require tests of the accounting records through inspection, observation or confirmation. Procedures for performing a review of interim financial information are ordinarily limited to making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures, rather than corroborating information obtained concerning significant accounting matters relating to the interim financial information.

The auditor's understanding of the entity and its environment including its internal control, the results of the risk assessments relating to the preceding audit and the auditor's consideration of materiality as it relates to the interim financial information, affects the nature and extent of the inquiries made, and analytical and other review procedures applied.

The auditor ordinarily performs the following procedures: -

- Reading the minutes of the meetings of shareholders, those charged with governance, and other appropriate committees to identify matters that may affect the interim financial information, and inquiring about matters dealt with at meetings for which minutes are not available that may affect the interim financial information.
- Considering the effect, if any, of matters giving rise to a modification of the audit or review report, accounting adjustments or unadjusted misstatements, at the time of the previous audit or reviews.
- Communicating, where appropriate, with other auditors who are performing a review of the interim financial information of the reporting entity's significant components.
- Inquiring of members of management responsible for financial and accounting matters, and others as appropriate about the following:
    - ♦ Whether the interim financial information has been prepared and presented in accordance with the applicable financial reporting framework.
    - ♦ Whether there have been any changes in accounting principles or in the methods of applying them.
    - ♦ Whether any new transactions have necessitated the application of a new accounting principle.
    - ♦ Whether the interim financial information contains any known uncorrected misstatements.

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- Unusual or complex situations that may have affected the interim financial information, such as a business combination or disposal of a segment of the business.
- Significant assumptions that are relevant to the fair value measurement or disclosures and management's intention and ability to carry out specific courses of action on behalf of the entity.
- Whether related party transactions have been appropriately accounted for and disclosed in the interim financial information.
- Significant changes in commitments and contractual obligations.
- Significant changes in contingent liabilities including litigation or claims.
- Compliance with debt covenants.
- Matters about which questions have arisen in the course of applying the review procedures.
- Significant transactions occurring in the last several days of the interim period or the first several days of the next interim period.
- Knowledge of any fraud or suspected fraud affecting the entity involving management, employees who have significant roles in internal control or others where the fraud could have a material effect on the interim financial information.
- Knowledge of any allegations of fraud, or suspected fraud, affecting the entity's interim financial information communicated by employees, former employees, analysts, regulators, or others.
- Knowledge of any actual or possible non-compliance with laws and regulations that could have a material effect on the interim financial information.

- Applying analytical procedures to the interim financial information designed to identify relationships and individual items that appear to be unusual and that may reflect a material misstatement in the interim financial information.
- Reading the interim financial information, and considering whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.

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The auditor may perform many of the review procedures before or simultaneously with the entity's preparation of the interim financial information. For example, it may be practicable to update the understanding of the entity and its environment, including its internal control, and begin reading applicable minutes before the end of the interim period.

Performing some of the review procedures earlier in the interim period also permits early identification and consideration of significant accounting matters affecting the interim financial information.

The auditor performing the review of interim financial information is also engaged to perform an audit of the annual financial statements of the entity. For convenience and efficiency, the auditor may decide to perform certain audit procedures concurrently with the review of interim financial information.

A review of interim financial information ordinarily does not require corroborating the inquiries about litigation or claims. It is, therefore, ordinarily not necessary to send an inquiry letter to the entity's lawyer. Direct communication with the entity's lawyer with respect to litigation or claims may, however, be appropriate if a matter comes to the auditor's attention that causes the auditor to question whether the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework, and the auditor believes the entity's lawyer may have pertinent information.

The auditor may obtain evidence that the interim financial information agrees or reconciles with the underlying accounting records by tracing the interim financial information to:	
(a)	The accounting records, such as the general ledger, or a consolidating schedule that agrees or reconciles with the accounting records; and
(b)	Other supporting data in the entity's records as necessary.

The auditor should inquire whether management has identified all events up to the date of the review report that may require adjustment to or disclosure in the interim financial information. It is not necessary for the auditor to perform other procedures to identify events occurring after the date of the review report.

The auditor should inquire whether management has changed its assessment of the entity's ability to continue as a going concern. When, as a result of this inquiry or other review procedures, the auditor becomes aware of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:

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(a) Inquire of management as to its plans for future actions based on its going concern assessment, the feasibility of these plans, and whether management believes that the outcome of these plans will improve the situation and

(b) Consider the adequacy of the disclosure about such matters in the interim financial information.

Events or conditions which may cast significant doubt on the entity's ability to continue as a going concern may have existed at the date of the annual financial statements or may be identified as a result of inquiries of management or in the course of performing other review procedures.

When such events or conditions come to the auditor's attention, the auditor inquires of management as to its plans for future action, such as its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital. The auditor also inquires as to the feasibility of management's plans and whether management believes that the outcome of these plans will improve the situation. *However, it is not ordinarily necessary for the auditor to corroborate the feasibility of management's plans and whether the outcome of these plans will improve the situation.*

When a matter comes to the auditor's attention that leads the auditor to question whether a material adjustment should be made for the interim financial information to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor should make additional inquiries or perform other procedures to enable the auditor to express a conclusion in the review report.

For example, if the auditor's review procedures lead the auditor to question whether a significant sales transaction is recorded in accordance with the applicable financial reporting framework, the auditor performs additional procedures sufficient to resolve the auditor's questions, such as discussing the terms of the transaction with senior marketing and accounting personnel, or reading the sales contract.

3.5 Evaluation of Misstatements

The auditor should evaluate, individually and in the aggregate, whether uncorrected misstatements that have come to the auditor's attention are material to the interim financial information.

Misstatements which come to the auditor's attention, including inadequate disclosures, are evaluated individually and in the aggregate to determine whether a material adjustment is required to be made to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework.

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The auditor exercises professional judgment in evaluating the materiality of any misstatements that the entity has not corrected.

3.6 Management representations

The auditor should obtain written representation from management that: -



(a) It acknowledges its responsibility for the design and implementation of internal control to prevent and detect fraud and error



(b) The interim financial information is prepared and presented in accordance with the applicable financial reporting framework



(c) It believes the effect of those uncorrected misstatements aggregated by the auditor during the review are immaterial, both individually and in the aggregate, to the interim financial information taken as a whole. A summary of such items is included in or attached to the written representations



(d) It has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity



(e) It has disclosed to the auditor the results of its assessment of the risks that the interim financial information may be materially misstated as a result of fraud



(f) It has disclosed to the auditor all known actual or possible non-compliance with laws and regulations whose effects are to be considered when preparing the interim financial information; and



(g) It has disclosed to the auditor all significant events that have occurred subsequent to the balance sheet date and through to the date of the review report that may require adjustment to or disclosure in the interim financial information.

3.7 Auditor's Responsibility for Accompanying Information

The auditor should read the other information that accompanies the interim financial information to consider whether any such information is materially inconsistent with the interim financial information.

If the auditor identifies a material inconsistency, the auditor considers whether the interim financial information or the other information needs to be amended. If an amendment is necessary in the interim financial information and management refuses to make such amendment, the auditor considers the implications for the review report.

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If an amendment is necessary in the other information and management refuses to make such amendment, the auditor considers including in the review report an additional paragraph describing the material inconsistency, or taking other actions, such as withholding the issuance of the review report or withdrawing from the engagement. For example, management may present alternative measures of earnings that more positively portray results of operations than the interim financial information, and such alternative measures are given excessive prominence, are not clearly defined, or not clearly reconciled to the interim financial information such that they are confusing and potentially misleading.

If a matter comes to the auditor's attention that causes the auditor to believe that the other information appears to include a material misstatement of fact, the auditor should discuss the matter with the entity's management.

While reading the other information for the purpose of identifying material inconsistencies, an apparent material misstatement of fact may come to the auditor's attention (i.e., information, not related to matters appearing in the interim financial information, that is incorrectly stated or presented). When discussing the matter with the entity's management, the auditor considers the validity of the other information and management's responses to the auditor's inquiries, whether valid differences of judgment or opinion exist and whether to request management to consult with a qualified third party to resolve the apparent misstatement of fact.

If an amendment is necessary to correct a material misstatement of fact and management refuses to make the amendment, the auditor considers taking further action as appropriate, such as notifying those charged with governance and obtaining a legal advice.

3.8 Communication

When, as a result of performing the review of interim financial information, a matter comes to the auditor's attention that causes the auditor to believe that it is necessary to make a material adjustment to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor should communicate this matter as soon as practicable to the appropriate level of management.

When, in the auditor's judgment, management does not respond appropriately within a reasonable period of time, the auditor should inform those charged with governance. The communication is made as soon as practicable, either orally or in writing. The auditor's decision whether to communicate orally or in writing is affected by factors such as the nature, sensitivity and significance

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of the matter to be communicated and the timing of such communications. If the information is communicated orally, the auditor documents the communication.

When, in the auditor's judgment, those charged with governance do not respond appropriately within a reasonable period, the auditor should consider		
(a) Whether to modify the report or	(b) The possibility of withdrawing from the engagement and	(c) The possibility of resigning from the appointment to audit the annual financial statements.

When, as a result of performing the review of interim financial information, a matter comes to the auditor's attention that causes the auditor to believe in the existence of fraud or noncompliance by the entity with laws and regulations, the auditor should communicate the matter as soon as practicable to the appropriate level of management. The determination of which level of management is the appropriate one is affected by the likelihood of collusion or the involvement of a member of management. The auditor also considers the need to report such matters to those charged with governance and considers the implication for the review.

The auditor should communicate relevant matters of governance interest arising from the review of interim financial information with those charged with governance. As a result of performing the review of the interim financial information, the auditor may become aware of matters that in the opinion of the auditor are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. The auditor communicates such matters to those charged with governance.

3.9 Reporting the Nature, Extent and Results of the Review of Interim Financial Information

The auditor should issue a written report that contains the following: -

Content of Written Report:	
(a)	An appropriate title.
(b)	An addressee, as required by the circumstances of the engagement.
(c)	Identification of the interim financial information reviewed, including identification of the title of each of the statements contained in the complete or condensed set of financial statements and the date and period covered by the interim financial information.

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(d) If the interim financial information comprises a complete set of general-purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, a statement that management is responsible for the preparation and fair presentation of the interim financial information in accordance with the applicable financial reporting framework.

(e) In other circumstances, a statement that management is responsible for the preparation and presentation of the interim financial information in accordance with the applicable financial reporting framework.

(f) A statement that the auditor is responsible for expressing a conclusion on the interim financial information based on the review.

(g) A statement that the review of the interim financial information was conducted in accordance with Standard on Review Engagements (SRE) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity," and a statement that that such a review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.

(h) A statement that a review is substantially less in scope than an audit conducted in accordance with Standards on Auditing and consequently does not enable the auditor to obtain assurance that the auditor would become aware of all significant matters that might be identified in an audit and that accordingly no audit opinion is expressed.

(i) If the interim financial information comprises a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information does not give a true and fair view, or does not present fairly, in all material respects, in accordance with the applicable financial reporting framework.

(j) In other circumstances, a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework

(k) The date of the report.

(l) Place of Signature.

(m) The auditor's signature and membership number assigned by the Institute of Chartered Accountants of India (ICAI).

(n) The Firm's registration number of the member of the Institute, wherever applicable, as allotted by ICAI.

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Besides, UDIN has also to be generated and stated for review engagement as it is also in nature of an assurance engagement. UDIN has to be stated for engagements performed in accordance with SRE 2400 or SRE 2410.

3.10 Departure from the Applicable Financial Reporting Framework

The auditor should express qualified or adverse conclusion when a matter has come to the auditor's attention that causes the auditor to believe that a material adjustment should be made to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework.

If matters have come to the auditor's attention that cause the auditor to believe that the interim financial information is or may be materially affected by a departure from the applicable financial reporting framework, and management does not correct the interim financial information, the auditor modifies the review report.

The modification describes the nature of the departure and, if practicable, states the effects on the interim financial information. If the information that the auditor believes is necessary for adequate disclosure is not included in the interim financial information, the auditor modifies the review report and, if practicable, includes the necessary information in the review report. The modification to the review report is ordinarily accomplished by adding an explanatory paragraph to the review report and qualifying the conclusion.

When the effect of the departure is so material and pervasive to the interim financial information that the auditor concludes a qualified conclusion is not adequate to disclose the misleading or incomplete nature of the interim financial information, the auditor expresses an adverse conclusion.

3.11 Limitation on Scope

A limitation on scope ordinarily prevents the auditor from completing the review. When the auditor is unable to complete the review, the auditor should communicate, in writing, to the appropriate level of management and to those charged with governance the reason why the review cannot be completed and consider whether it is appropriate to issue a report.

3.11.1 Limitation on Scope Imposed by Management

The auditor does not accept an engagement to review the interim financial information if the auditor's preliminary knowledge of the engagement circumstances indicates that the auditor would be unable to complete the review because there will be a limitation on the scope of the auditor's review imposed by the management of the entity.

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If, after accepting the engagement, management imposes a limitation on the scope of the review, the auditor requests the removal of that limitation. If management refuses to do so, the auditor is unable to complete the review and express a conclusion. In such cases, the auditor communicates, in writing, to the appropriate level of management and those charged with governance the reason why the review cannot be completed. Nevertheless, if a matter comes to the auditor's attention that causes the auditor to believe that a material adjustment to the interim financial information is necessary for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor communicates such matters.

The auditor also considers the legal and regulatory responsibilities, including whether there is a requirement for the auditor to issue a report. If there is such a requirement, the auditor disclaims a conclusion, and provides in the review report the reason why the review cannot be completed. However, if a matter comes to the auditor's attention that causes the auditor to believe that a material adjustment to the interim financial information is necessary for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor also communicates such a matter in the report.

3.11.2 Other Limitations on Scope

A limitation on scope may occur due to circumstances other than a limitation on scope imposed by management. In such circumstances, the auditor is ordinarily unable to complete the review and express a conclusion. There may be, however, some rare circumstances where the limitation on the scope of the auditor's work is clearly confined to one or more specific matters that, while material, are not in the auditor's judgment pervasive to the interim financial information. In such circumstances, the auditor modifies the review report by indicating that, except for the matter which is described in an explanatory paragraph to the review report, the review was conducted in accordance with this SRE, and by qualifying the conclusion.

The auditor may have expressed a qualified opinion on the audit of the latest annual financial statements because of a limitation on the scope of that audit. The auditor considers whether that limitation on scope still exists and, if so, the implications for the review report.

3.12 Going Concern and Significant Uncertainties

If, as a result of inquiries or other review procedures, a material uncertainty relating to an event or condition comes to the auditor's attention that may cast significant doubt on the entity's ability to continue as a going concern, and adequate disclosure is made in the interim financial information the auditor modifies the review report by adding an emphasis of matter paragraph.

The auditor may have modified a prior audit or review report by adding an emphasis of matter paragraph to highlight a material uncertainty relating to an event or condition that may cast

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significant doubt on the entity's ability to continue as a going concern. If the material uncertainty still exists and adequate disclosure is made in the interim financial information, the auditor modifies the review report on the current interim financial information by adding a paragraph to highlight the continued material uncertainty.

If a material uncertainty that casts significant doubt about the entity's ability to continue as a going concern is not adequately disclosed in the interim financial information, the auditor should express a qualified or adverse conclusion, as appropriate. The report should include specific reference to the fact that there is such a material uncertainty.

3.13 Other Considerations

The terms of the engagement include management's agreement that where any document containing interim financial information indicates that such information has been reviewed by the entity's auditor, the review report will also be included in the document. If management has not included the review report in the document, the auditor considers seeking legal advice to assist in determining the appropriate course of action in the circumstances.

If the auditor has issued a modified review report and management issues the interim financial information without including the modified review report in the document containing the interim financial information, the auditor considers seeking legal advice to assist in determining the appropriate course of action in the circumstances, and the possibility of resigning from the appointment to audit the annual financial statements.

Interim financial information consisting of a condensed set of financial statements does not necessarily include all the information that would be included in a complete set of financial statements, but may rather present an explanation of the events and changes that are significant to an understanding of the changes in the state of affairs and performance of the entity since the annual reporting date. This is because it is presumed that the users of the interim financial information will have access to the latest audited financial statements, such as is the case with listed entities.

In other circumstances, the auditor discusses with management the need for such interim financial information to include a statement that it is to be read in conjunction with the latest audited financial statements. In the absence of such a statement, the auditor considers whether, without a reference to the latest audited financial statements, the interim financial information is misleading in the circumstances, and the implications for the review report.

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3.14 Documentation

The auditor should prepare review documentation that is sufficient and appropriate to provide a basis for the auditor's conclusion and to provide evidence that the review was performed in accordance with this SRE and applicable legal and regulatory requirements.

TEST YOUR UNDERSTANDING 3

During review of the quarterly results of a company of which you are auditor, it is gathered on inquiries made that there has been a major fire in fabric processing plant of the company during the quarter. It has resulted in massive disruption in the operations of the company. Worse still, machinery and inventories of plant were uninsured due to carelessness of concerned staff leading to substantial losses. The matter has been disclosed in interim financial information appropriately. Discuss how you would proceed to deal with the same in the review report.

TEST YOUR UNDERSTANDING 4

CA Seerat is conducting review of the quarterly financial information of a company of which she is also auditor. She believes that it is necessary to make a material adjustment to the quarterly financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework. She has communicated the matter to the CFO and the audit committee. However, no response was received even after waiting for a reasonable time. What are the options available to her?

Integrated Case Scenario

Below is given an *incomplete* draft text of the review report on the review of financial results of *Fast Operations Limited*, a listed company in accordance with SEBI regulations. The review is a compulsory requirement under SEBI (Listing Obligations and Disclosure Requirements) Regulations. The incomplete areas of the report have been marked as ***XXXX.***

INDEPENDENT AUDITOR'S REVIEW REPORT ON REVIEW OF INTERIM STANDALONE FINANCIAL RESULTS

TO XXXX

1. We have reviewed the accompanying Statement of Standalone unaudited financial results of *Fast Operations Limited* ("the Company"), for the quarter and six months ended September 30, 2024 ("the Statement"), being submitted by the Company pursuant to the

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requirement of Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended.

2. This Statement, which is the responsibility of the Company's Management and approved by the Company's Board of Directors, has been prepared in accordance with the recognition and measurement principles laid down in the Indian Accounting Standard 34 "Interim Financial Reporting" ("Ind AS 34"), prescribed under Section 133 of the Companies Act, 2013 read with relevant rules issued thereunder and other accounting principles generally accepted in India. Our responsibility ***XXXXXXXXXX***.

3. We conducted our review of the Statement in accordance with the Standard ***XXXX***, issued by the Institute of Chartered Accountants of India (ICAI). A review of interim financial information consists of making inquiries, primarily of the company's personnel responsible for financial and accounting matters and applying analytical and other review procedures. A review is substantially ***XXXXXXXXXXXXXXXXXXXXXXXX***.

4. Based on our review conducted as stated in paragraph 3 above, ***XXXXXXXXXXXXXXXXXXXXXXXXXXXX***

Using your knowledge, answer the following questions to complete the draft text of review report of *Fast Operations Limited*: -

1. The name of addressee is missing from text of draft review report. Identify the most appropriate option:

(a) Audit Committee

(b) Board of Directors

(c) CFO

(d) Stock exchange on which shares of company are listed

2. Under para 2 of the case study, choose the appropriate sentence beginning with "Our responsibility XXXX":

(a) Our responsibility is to express an opinion on the Statement based on our review.

(b) Our responsibility is to express a conclusion on the Statement based on our review.

(c) Our responsibility is to provide a reasonable assurance on the Statement based on our review.

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(d) Our responsibility is to express a compliance statement on the Statement based on our review.

3. Given the description of case study, which of the following engagement standards is most appropriate to be stated in para 3?

(a) SRE 2410 'Review of Interim Financial Information Performed by the Independent Auditor of the Entity'.

(b) SRE 2400 Engagements to Review Historical Financial Statements.

(c) SA 700 Forming an Opinion and Reporting on Financial Statements.

(d) SA 810 Engagements to Report on Summary Financial Statements.

4. Which of the following statements is most appropriate to be inserted in sentence beginning with "A review is substantially XXXX" in para 3?

(a) A review is substantially broader in scope than an audit conducted in accordance with Standards on Auditing specified under section 143(10) of the Companies Act, 2013 and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in a review. Accordingly, we do not express an audit opinion.

(b) A review is substantially broader in scope than an audit conducted in accordance with Standards on Auditing specified under section 143(10) of the Companies Act, 2013 and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

(c) A review is substantially narrower in scope than an audit conducted in accordance with Standards on Auditing specified under section 143(10) of the Companies Act, 2013 and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in a review. Accordingly, we do not express an audit opinion.

(d) A review is substantially less in scope than an audit conducted in accordance with Standards on Auditing specified under section 143(10) of the Companies Act, 2013 and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

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5. Complete the paragraph 4 of case study from following options: -

(a) Nothing has come to our attention that causes us to believe that the accompanying Statement, prepared in accordance with the recognition and measurement principles laid down in the aforesaid Indian Accounting Standard and other accounting principles generally accepted in India, has not disclosed the information required to be disclosed in terms of Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended, including the manner in which it is to be disclosed, or that it contains any material misstatement.

(b) Nothing has come to our attention that causes us to believe that the accompanying Statement, prepared in accordance with the recognition and measurement principles laid down in the aforesaid Indian Accounting Standard and other accounting principles generally accepted in India, has disclosed the information required to be disclosed in terms of Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended, including the manner in which it is to be disclosed, or that it does not contain any material misstatement.

(c) The accompanying Statement, prepared in accordance with the recognition and measurement principles laid down in the aforesaid Indian Accounting Standard and other accounting principles generally accepted in India, has disclosed the information required to be disclosed in terms of Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended, including the manner in which it is to be disclosed, or that it does not contain any material misstatement.

(d) The accompanying Statement, prepared in accordance with the recognition and measurement principles laid down in the aforesaid Indian Accounting Standard and other accounting principles generally accepted in India, has disclosed the information required to be disclosed in terms of Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended, including the manner in which it is to be disclosed, or that it does not contain any material misstatement and gives a true and fair view of the state of affairs of the company as on date of interim financial statements.

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Key Takeaways

- "Review" is a *limited assurance* engagement. Limited assurance engagement provides lower level of assurance than audit. It involves fewer procedures and gathers sufficient appropriate evidence on basis of which limited conclusions can be drawn up.
- Standards on review engagements apply where "review" of financial information is undertaken by the practitioner. SRE 2400 and SRE 2410 have been issued in this regard.
- SRE 2400 deals with the practitioner's responsibilities performing a review of historical financial statements when the practitioner is not the auditor of the entity's financial statements.
- The practitioner's objectives in accordance with SRE 2400 includes obtaining limited assurance, primarily by performing inquiry and analytical procedures, about whether the financial statements as a whole are free from material misstatement and to report on the financial statements as a whole and communicate, as required by this SRE.
- Prior to accepting a review engagement, the practitioner shall determine that preconditions for accepting a review engagement exist.
- The practitioner performs review engagement mainly focussing upon inquiry and analytical procedures. Besides, procedures to address specific circumstances, are also performed. Additional procedures are also performed when the practitioner becomes aware that the financial statements may be materially misstated.
- Written representations are obtained and evidence from performing procedures is evaluated. Limited conclusions are drawn, and a review report is issued.
- SRE 2410 applies when review of interim financial information is performed by the independent auditor of the financial statements of the entity.
- Interim financial information is financial information that is prepared and presented in accordance with an applicable financial reporting framework and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year.
- The objective of an engagement to review interim financial information is to enable the auditor to express a conclusion whether, on the basis of the review, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is

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not prepared, in all material respects, in accordance with an applicable financial reporting framework.

- The auditor makes inquiries and performs analytical and other review procedures in order to reduce to a moderate level the risk of expressing an inappropriate conclusion when the interim financial information is materially misstated.
- Review documentation should be prepared that is sufficient and appropriate to provide a basis to provide evidence that the review was performed in accordance with requirements.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Discuss why "inquiry" is important as an audit procedure in an engagement to review financial statements.*
2. *CA Aditya Jain is auditor of a listed company. He is also required to carry out a quarterly review of financial statements of company in terms of regulatory requirements. He is already well-versed with the business of the company and has a deep understanding of the company. Discuss any of the five procedures by which he can update his understanding of the company for carrying out quarterly review.*
3. *What is significance of "date of report" in a review report?*
4. *CA Pankaj Chaturvedi has issued a review report dated 28-07-2024 for the financial results of a company for quarter ending 30-06-2024. Describe his responsibility, if any, for events occurring from 01-07-2024 till date of review report in accordance with SRE 2410.*
5. ***A review of financial statements includes consideration of the entity's ability to continue as a going concern. If, during the performance of the review, the practitioner becomes aware of events or conditions that may cast significant doubt about the entity's ability to continue as a going concern. Enumerate the steps to be taken by the practitioner for the same.***
6. ***GAK Limited has compiled the interim financial information, as per the Listing agreement requirements, and submitted it to the auditors for their review. CA Reena has been assigned on the engagement to review the interim financial information of GAK Limited. Based on the inquiries and other review procedures carried out, CA Reena assessed that GAK Limited has been facing continuous working capital***

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shortages. No financial institutions or banks are ready to lend additional funding limits to GAK Limited, since the company has been continuously incurring losses for over 3 years and the company has defaulted payment of loan instalments & interest over the last one year and operations have been curtailed significantly.

Under such circumstances CA Reena, who is doing the review for the first time, noted that GAK Limited has not disclosed any information in the interim financial information relating to material uncertainties. Given the situation, please advise CA Reena, what kind of review report is required to be issued? If, GAK Limited has disclosed information relating to material uncertainty, can CA Reena give a clean report? Discuss.

7. ***In a review engagement performed under SRE 2400, practitioner relies mainly on certain procedures. Naming such procedures, discuss the importance of these procedures in a review engagement.***

Practitioner's report containing outcome of review engagement in form of "conclusion" also contains a description of a review of financial statements and its limitations. Which statements in this respect are to be included in the practitioner's report in accordance with SRE 2400?

Answers to Test Your Understanding

1. The above financial statements are prepared in accordance with the special purpose framework in accordance with requirements of a contract. Financial statements prepared in accordance with the special purpose framework can also be reviewed by a professional accountant in practice and review report may be issued in accordance with SRE 2400.

2. If the practitioner becomes aware of matters that causes the practitioner to believe the financial statements may be materially misstated, the practitioner shall design and perform additional procedures sufficient to enable the practitioner to: -

(a) Conclude that the matter(s) is not likely to cause the financial statements as a whole to be materially misstated or

(b) Determine that the matter(s) causes the financial statements as a whole to be materially misstated.

Additional procedures focus on obtaining sufficient appropriate evidence to enable the practitioner to form a conclusion on matters that the practitioner believes may cause the financial statements to be materially misstated. The procedures may be:

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- Additional inquiry or analytical procedures, for example, being performed in greater detail or being focused on the affected items (i.e. amounts or disclosures concerning the affected accounts or transactions as reflected in the financial statements); or
- Other types of procedures, for example, substantive test of details or external confirmations.

3. Uninsured assets in a disaster are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. As a result of the fire, there is massive disruption in the operations of the company. Besides, the company would have to bear losses as its damaged assets are uninsured.

In accordance with SRE 2410, if, as a result of inquiries or other review procedures, a material uncertainty relating to an event or condition comes to the auditor's attention that may cast significant doubt on the entity's ability to continue as a going concern, and adequate disclosure is made in the interim financial information, the auditor modifies review report by adding an emphasis of matter paragraph.

Therefore, Emphasis of Matter paragraph should be added in review report.

4. In such a case, options available to her in accordance with SRE 2410 are: -

(a) Whether to modify the report or

(b) The possibility of withdrawing from the engagement and

(c) The possibility of resigning from the appointment to audit the annual financial statements.

Answers to Integrated Case Scenario

1. (b) **2.** (b) **3.** (a) **4.** (d) **5.** (a)

Answers to Theoretical Questions

1. Refer to Para 2.4.

2. Refer to Para 3.3.

3. Refer to Para 2.4.

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4. The auditor should inquire whether management has identified all events up to the date of the review report that may require adjustment to or disclosure in the interim financial information.

5. Refer to Para 2.4

6. Going Concern and Significant Uncertainties: As per SRE 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity", if, as a result of inquiries or other review procedures, a material uncertainty relating to an event or condition comes to the auditor's attention that may cast significant doubt on the entity's ability to continue as a going concern, and adequate disclosure is made in the interim financial information the auditor modifies the review report by adding an emphasis of matter paragraph.

The auditor may have modified a prior audit or review report by adding an emphasis of matter paragraph to highlight a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern.

If a material uncertainty that casts significant doubt about the entity's ability to continue as a going concern is not adequately disclosed in the interim financial information, the auditor should express a qualified or adverse conclusion, as appropriate. The report should include specific reference to the fact that there is such a material uncertainty.

In view of the above, in the given situation, GAK Limited has compiled the interim financial information, as per the Listing agreement requirements, and submitted it to the auditors for their review. CA Reena has been assigned on the engagement to review the interim financial information of GAK Limited. CA Reena noticed that GAK Limited has not disclosed any information in the interim financial information relating to material uncertainties that casts significant doubt about the entity's ability to continue as a going concern. Thus, the auditor should express a qualified or adverse conclusion, as appropriate. The report should include specific reference to the fact that there is such a material uncertainty.

If the material uncertainty still exists and adequate disclosure is made in the interim financial information, the auditor modifies the review report on the current interim financial information by adding a paragraph to highlight the continued material uncertainty. If GAK Limited has disclosed information relating to material uncertainties, CA Reena should modify the review report by adding an emphasis of matter paragraph.

7. Refer to Para 2.4.

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CHAPTER 11

PROSPECTIVE FINANCIAL INFORMATION AND OTHER ASSURANCE SERVICES



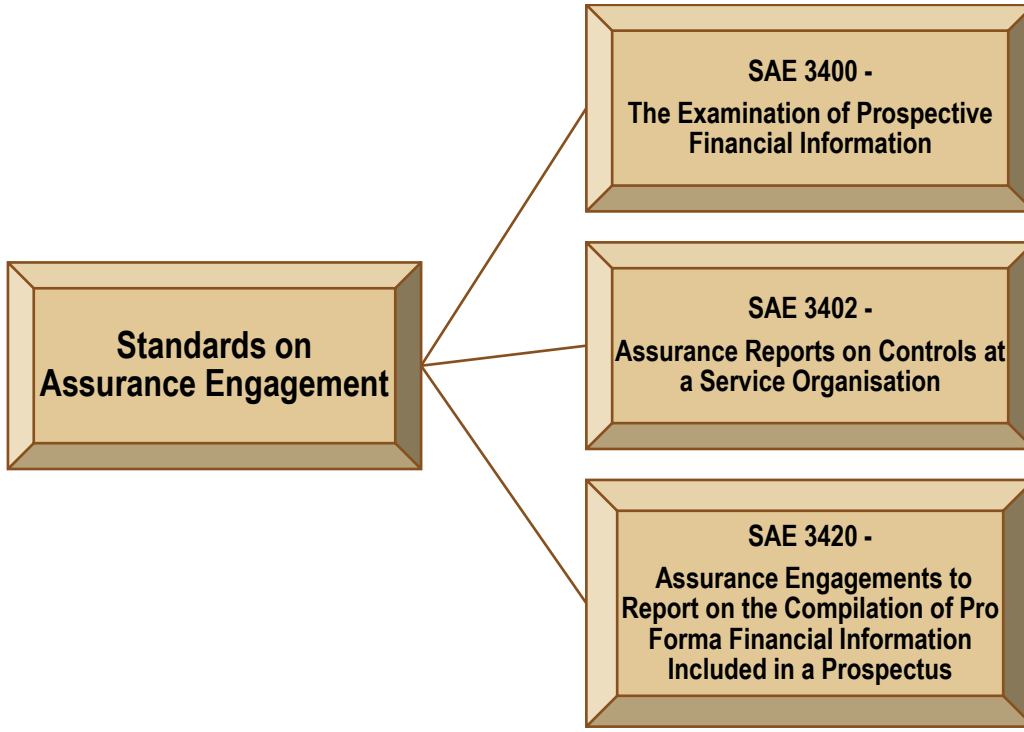
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Gain knowledge about Standards on Assurance Engagements.
- Understand the meaning of Prospective financial information.
- Know about the responsibilities of professional accountants in examining and reporting on prospective financial information under SAE 3400.
- Understand the meaning of Service Organization.
- Understand the importance of controls of a service organization to a user entity's internal controls relating to financial reporting.
- Know about the responsibilities of professional accountants under SAE 3402.
- Understand the meaning of Pro forma financial information.
- Understand about responsibilities of practitioners in assurance engagements to report on the compilation of Pro forma financial information included in a prospectus under SAE 3420.

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CHAPTER OVERVIEW



XP Limited, a company engaged in manufacturing of paints, is set to launch a new project for setting up a food processing plant at NOIDA lured by slew of investor friendly measures announced by state government in recently held Global Investors Summit. Being a new line of activity for the company, it asks Chirag (having MBA finance qualification) employed as a senior finance executive in the company to prepare detailed projection and feasibility of the said project. The company management wants him to make a detailed study conforming to acquisition of land, construction of plant building, procurement of plant machinery, projected targets of turnover, profits, sources of funds including financial assistance to be taken from banks etc. The said study is also to be used for submission to bankers for borrowing purpose.

Adept in preparing such studies, he prepared such a projection considering above factors highlighting expected sales, profits, key financial ratios, debt service coverage ratio over a period of seven years, payback period and IRR (Internal rate of return) replete with charts, bar graphs and diagrams. The said study was also submitted to bankers for providing financial assistance for upcoming project of the company.

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The bankers of the company now require an assurance report from a professional accountant on information contained in above study. Bewildered to know this, he wanted to understand reason of such a report from a professional accountant. Coming back to his office, he discussed the matter with CFO who asked him to meet CA. Dilip in this regard.

During discussions with CA, it transpired that for issuance of such an assurance report, it would be examined whether prospective financial information is prepared on the basis of assumptions; whether such assumptions are not unreasonable and are consistent with purpose of study. Not only this, but it would also be looked into whether such information is consistent with past financial statements and uses appropriate accounting principles. He started groundwork in these areas as instructed by CFO before engaging services of professional accountant.

Learning about assurance report on prospective financial information, he was also wondering whether professional accountants can also provide such reports intended to enhance degree of confidence of users in respect of non-financial matters. What could be such circumstances? What could be such type of matters?

1. INTRODUCTION

Traditionally, the attest function performed by a Chartered Accountant in practice has been in relation to past events. However, growing and dynamic society has now started seeking professional association in its exercises relating to future. A manifestation of this is the requirement of banks, financial institutions and prospective investors regarding the preparation of projected cash flow and profitability statements by intending borrowers or investees for the purpose of making an appropriate appraisal of their loan applications and equity proposals. These institutions place a greater reliance on such statements if they are prepared or reviewed by chartered accountants. These future oriented financial statements are generally known as Prospective Financial Statements.



The shareholders of X Limited have given consent to board of directors to plan to raise funds from the prospective equity investor and have asked your firm to report on the accuracy of the profit forecast and Statements of Financial Position of the entity for the following five years so that it could be placed before the equity investor.

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1.1 Standards on Assurance Engagements

An assurance engagement may relate to examination of subject matters other than examination of financial statements prepared on basis of "historical financial information". In such type of assurance engagements, examination may relate to prospective financial information or to providing assurance regarding non-financial matters like design and operation of internal control in an entity.

Standards on Assurance Engagements deal with responsibilities of professional accountants in assurance engagements dealing such matters. The level of assurance provided by these Standards on Assurance Engagements is moderate.

Following Standards on Assurance Engagements have been issued: -
• SAE 3400 The Examination of Prospective Financial Information.
• SAE 3402 Assurance Reports on Controls at a Service Organisation.
• SAE 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus.

2. SAE 3400 "THE EXAMINATION OF PROSPECTIVE FINANCIAL INFORMATION"

SAE 3400 provides guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions. Examination of prospective financial information need not necessarily be performed by statutory auditor of the entity's financial statements.

What is Prospective financial information?

"Prospective financial information" is financial information based on:

- Assumptions about events that may occur in the future and
- Possible actions by an entity.

It is highly subjective in nature and its preparation requires the exercise of considerable judgment. Prospective financial information can be in the form of :

- a forecast,
- a projection,
- or a combination of both (for example a 1-year, forecast plus a 5-year, projection.)

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What is Forecast?

Forecast means Prospective Financial Information prepared on the basis of:

- Assumptions as to future events which management expects to take place and
- The actions management expects to take as of the date the information is prepared. (Best-estimate assumptions- An assumption that reflects anticipated experience with no provision for risk of adverse deviation).



In present market conditions, supply availability, historical buying patterns and seasonal trends, the CFO of X Ltd. a expects sales to increase by 5% over the next quarter. Therefore, a 5% sales increase is his financial forecast for the period.

What is Projection?

Prospective Financial Information prepared on the basis of:

- Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or
- A mixture of best-estimate and hypothetical assumptions (imagined or suggested).



1. X Ltd may project a course of action to take when one or more hypothetical situations arise, such as creating a new product to meet the demand of expected market growth. As a result of assuming the possibility of different events occurring, financial projections typically serve as an outline for evaluating the desired outcomes X Ltd. is expects to see, including its financial, cash flow and operational outcomes.



2. A company plans to raise funds from a prospective equity investor and has asked a firm of Chartered Accountants to examine the profit forecast for placing it before prospective equity investor.



3. A company is in the process of setting up a new plant. It needs financial assistance from bank in shape of term loan and working capital credit facilities. The company has prepared a projection of its profits, cash flows for next seven years along with its underlying assumptions.

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2.1 Scope of SAE 3400

The purpose of this Standard on Assurance Engagement (SAE) is to establish standards and provide guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions.

This SAE does not apply to the examination of prospective financial information expressed in general or narrative terms, such as that found in management's discussion and analysis in an entity's annual report, though many of the procedures outlined herein may be suitable for such an examination. Further, the principles laid down in the other Standards on Auditing, issued by the Institute of Chartered Accountants of India, should be used by the auditor, to the extent practicable, in applying this SAE.

The term "auditor" is used throughout this SAE when describing services involving examination of prospective financial information. Such reference is not intended to imply that a member performing such services need necessarily be the statutory auditor of the entity's financial statements.

2.2 Nature of Assurance Regarding Prospective Financial Information

Prospective financial information relates to events and actions that have not yet occurred and might not occur. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented and, therefore, speculative in nature, as distinct from the evidence ordinarily available in the examination of historical financial information. Therefore, an opinion as to whether the results shown in the prospective financial information will be achieved cannot be expressed.

2.3 Responsibility of Preparation and Presentation of Prospective Financial Information

Management is responsible for the preparation and presentation of the prospective financial information including the:

- Identification and disclosure of Prospective Financial Information;
- Explaining the basis of forecast;
- Underlying assumptions.

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Can Professional Accountants be associated with Prospective Financial Information ?

Traditionally, the attest function performed by a Chartered Accountant in practice has been in relation to "historical financial information". Recognizing the professional skill and competence of Chartered accountants, varied stakeholders like banks, financial institutions and prospective investors intend to place greater reliance on reports of projected cash flow and profitability statements examined and signed by Chartered accountants.

Clause 3 of the Second Schedule to the Chartered Accountants Act, 1949 states that that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a *manner which may lead to the belief that he vouches for the accuracy of the forecast.*

The above clause *does not preclude* a Chartered accountant from associating his name with prospective financial statements. A chartered accountant can participate in the preparation of profit or financial forecasts and can review them, provided he indicates clearly in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and *so long as he does not vouch for the accuracy of the forecasts.*

The same also applies to projections made on the basis of hypothetical assumptions about future events and management actions which are not necessarily expected to take place *so long as vouching for the accuracy of the projection is not made.*

2.4 Duties of Member who is Examining the Prospective Financial Information

In an engagement to examine prospective financial information, the auditor should obtain sufficient appropriate evidence as to whether:	
(a)	management's best-estimate assumptions on which the prospective financial information is based **are not unreasonable** and, in the case of hypothetical assumptions, such **assumptions are consistent with the purpose of the information;**
(b)	the prospective financial information is **properly prepared on the basis of the assumptions**;
(c)	the prospective financial information is **properly presented** and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; and
(d)	the prospective financial information is prepared **on a consistent basis** with historical financial statements, using appropriate accounting principles.

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While examining prospective financial information, principles laid down in other Standards on Auditing should be applied to the extent practicable.

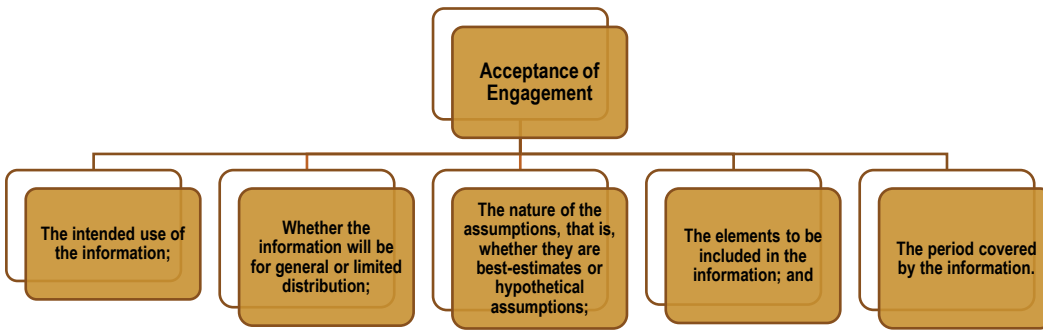
2.5 Nature of Assurance regarding Prospective Financial Information

Prospective financial information relates to events and actions that have not yet occurred and might not occur. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented and, therefore, speculative in nature, as distinct from the evidence ordinarily available in the examination of historical financial information. Therefore, an opinion as to whether the results shown in the prospective financial information will be achieved cannot be expressed.

2.6 Acceptance of Engagement: Precautions to be taken by Auditor Before Accepting such an Engagement

Before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:

- The intended use of the information;
- Whether the information will be for general or limited distribution;
- The nature of the assumptions, that is, whether they are best estimates or hypothetical Assumptions;
- The elements to be included in the information; and
- The period covered by the information.



Further, the auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use. The auditor should consider the extent to which

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reliance on the entity's historical financial information is justified. Like in other engagements, it is necessary that terms of engagements should be agreed with client by sending an engagement letter.

2.7 Examination Procedures

When determining the nature, timing and extent of examination procedures, the following matters should be considered such as: -

Examination Procedures	**(a) the knowledge obtained during any previous engagements**
	(b) management's competence regarding the preparation of prospective financial information
	(c) the likelihood of material misstatement
	(d) the extent to which the prospective financial information is affected by the management's judgment
	(e) the sources of information considered by the management for the purpose, their adequacy, reliability of the underlying data, including data derived from third parties, such as industry statistics, to support the assumptions
	(f) the stability of entity's business and
	(g) the engagement team's experience with the business and the industry in which the entity operates and with reporting on prospective financial information

In performing these procedures, source and reliability of the evidence supporting management's best-estimate assumptions needs to be assessed. Such evidence may be available from varied sources like entity's budgets, debt agreements, industry publications etc.

When hypothetical assumptions are used, all significant implications of such assumptions should have been taken into consideration. For example, if sales are assumed to grow beyond the entity's current plant capacity, the prospective financial information will need to include the necessary investment in the additional plant capacity or the costs of alternative means of meeting the anticipated sales, such as subcontracting production. It needs to be verified that the hypothetical assumptions are consistent with the purpose of the prospective financial information and that there is no reason to believe they are clearly unrealistic.

2.8 Presentation and Disclosure

When assessing the presentation and disclosure of the prospective financial information and the underlying assumptions, in addition to the specific requirements of any relevant statutes, regulations as well as the relevant professional pronouncements, it needs to be considered whether: -

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(a) the presentation of prospective financial information is *informative and not misleading;*

(b) the *accounting policies are clearly disclosed* in the notes to the prospective financial information;

(c) the *assumptions are adequately disclosed* in the notes to the prospective financial information. It needs to be clear whether assumptions represent management's best-estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this *uncertainty and the resulting sensitivity of results needs to be adequately disclosed;*

(d) the *date as of which the prospective financial information was prepared is disclosed.* Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time;

(e) *the basis of establishing points in a range is clearly indicated* and the range is not selected in a biased or misleading manner when results shown in the prospective financial information are expressed in terms of a range; and

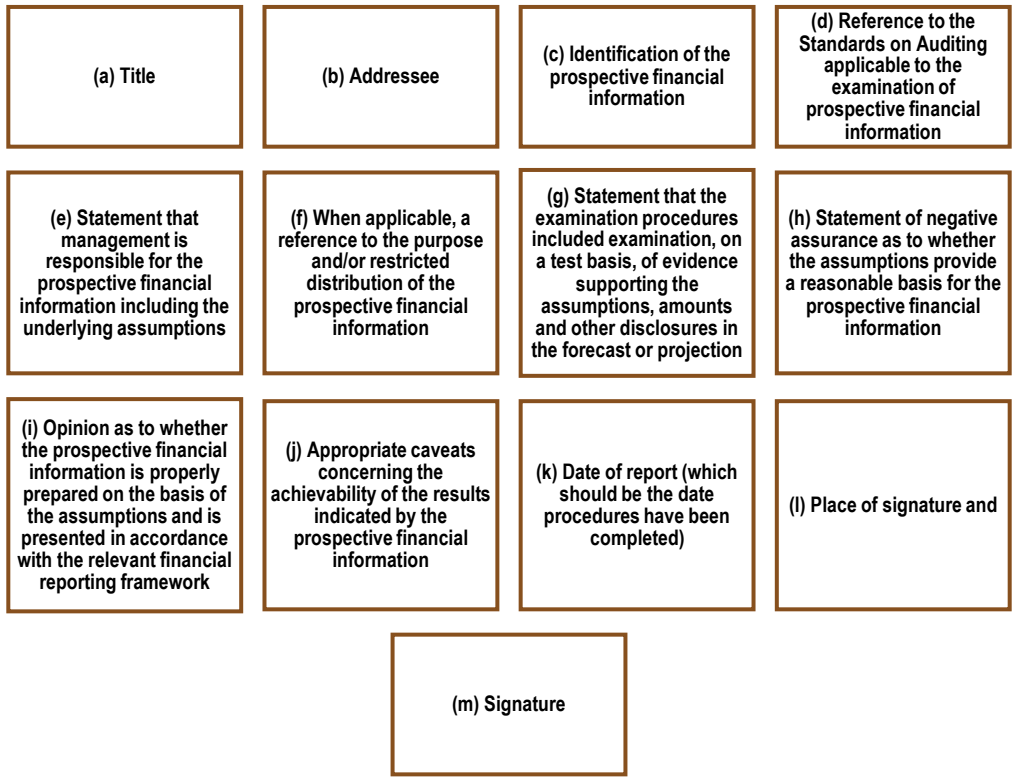
(f) if there is *any change in the accounting policy* of the entity from that disclosed in the most recent historical financial statements, whether reason for the change and the effect of such change on the prospective financial information has been adequately disclosed.

2.9 Report on Examination of Prospective Financial Information

The report for an examination of prospective financial information should contain the following:	
(a)	Title;
(b)	Addressee;
(c)	Identification of the prospective financial information;
(d)	Reference to the Standards on Auditing applicable to the examination of prospective financial information;
(e)	Statement that management is responsible for the prospective financial information including the underlying assumptions;
(f)	When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information;
(g)	Statement that the examination procedures included examination, on a test basis, of evidence supporting the assumptions, amounts and other disclosures in the forecast or projection;
(h)	Statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information;

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(i)	Opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework;
(j)	Appropriate caveats concerning the achievability of the results indicated by the prospective financial information;
(k)	Date of report (which should be the date procedures have been completed);
(l)	Place of signature; and
(m)	Signature.



Such a report would: -

- **state** whether, based on the examination of the evidence supporting the assumptions, anything has come to attention, which causes the belief that the assumptions do not provide a reasonable basis for the prospective financial information.

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- **express** an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework.
- **state that: -**

Actual results are likely to be different from the prospective financial information since anticipated events frequently do not occur as expected and the variation could be material. Likewise, when the prospective financial information is expressed as a range, it would be stated that there can be no assurance that actual results will fall within the range and

In the case of a projection, the prospective financial information has been prepared for (intended use), using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that the prospective financial information should not be used for purposes other than the abovementioned intended use.

When it is believed that the presentation and disclosure of the prospective financial information is not adequate, a qualified or adverse opinion in the report on the prospective financial information should be expressed or withdrawal from engagement should be made as appropriate.

An example would be where financial information fails to disclose adequately the consequences of any assumptions, which are highly sensitive.

When it is believed that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, an adverse opinion setting out the reasons in the report on the prospective financial information should be expressed, or withdrawal from the engagement should be made.

When the examination is affected by conditions that preclude application of one or more procedures considered necessary in the circumstances, either withdrawal from the engagement or disclaimer of the opinion and describing the scope limitation in the report on the prospective financial information is considered.

2.10 Documentation

Matters, which are important in providing evidence to support report on examination of prospective financial information, and evidence that such examination was carried out in accordance with this SAE should be documented.

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TEST YOUR UNDERSTANDING 1

A company has approached CA. Hemant for an assurance report in respect of prospective financial information of a project. On going through the project details, it is noticed that depreciation reflected on proposed fixed assets to be acquired in prospective financial information has been calculated in accordance with provisions of the Income Tax Act. No disclosure is made in this respect too. How the matter should be proceeded with?

3. SAE 3402 "Assurance Reports on Controls at a Service Organisation"

SAE 3402 deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting. It complements SA 402, in that reports prepared in accordance with this SAE are capable of providing appropriate evidence under SA 402.

3.1 Scope of SAE 3402

SAE 3402 applies only when the service organization is responsible for, or otherwise able to make an assertion about, the suitable design of controls. It does not deal with assurance engagements:	
(a)	To report only on whether controls at a service organization operated as described; or
(b)	To report only on controls at a service organization other than those related to a service that is likely to be relevant to user entities' internal control as it relates to financial reporting (for example, controls that affect user entities' production or quality control).

What is a Service Organisation?

Service organization refers to a third-party organization (or segment of a third-party organization) that provides services to user entities that are likely to be relevant to user entities internal control as it relates to financial reporting. User entity refers to an entity that uses a service organization.

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Why controls of a service organization are important to a user entity's internal controls relating to financial reporting?

Controls related to a service organization's operations and compliance objectives may be relevant to a user entity's internal control as it relates to financial reporting. Such controls may pertain to assertions about presentation and disclosure relating to account balances, classes of transactions, or disclosures, or may pertain to evidence that the user auditor evaluates or uses in applying auditing procedures.

For example, a company has outsourced its payroll processing functions to a service organization. The service organization is responsible for the accurate preparation of payrolls and timely remittance of statutory dues to government authorities on behalf of the company. Payroll processing service organization's controls related to the timely remittance of payroll deductions to government authorities may be relevant to the company (user entity) as late remittances could result in interest and penalties resulting in liabilities for the user entity.

"*Controls at the service organization"* includes aspects of user entities' information systems maintained by the service organization and may also include aspects of one or more of the other components of internal control at a service organization.

For example, such controls at a service organization may include aspects of a service organization's control environment, monitoring, and control activities when they relate to the services provided. *It does not, however, include controls at a service organization that are not related to the achievement of the control objectives stated in the service organization's description of its system, for example, controls related to the preparation of the service organization's own financial statements.*

The determination of whether controls at a service organization related to operations and compliance are likely to be relevant to user entities' internal control as it relates to financial reporting is a matter of professional judgment, having regard to the control objectives set by the service organization and the suitability of the criteria.

User Auditor and Service Auditor

User auditor refers to an auditor who audits and reports on the financial statements of a user entity.

Service auditor refers to a professional accountant in public practice who, at the request of the service organization, provides an assurance report on controls at a service organization.

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3.2 Objectives of Service Auditor in Accordance with SAE 3402

The objectives of the service auditor are: -
(a) To obtain reasonable assurance about whether, in all material respects, based on suitable criteria: - (i) The service organization's description of its system fairly presents the system as designed and implemented throughout the specified period *(or in the case of a type 1 report, as at a specified date)*. (ii) The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period *(or in the case of a type 1 report, as at a specified date)*. (iii) Where included in the scope of the engagement, the controls operated effectively to provide reasonable assurance that the control objectives stated in the service organization's description of its system were achieved throughout the specified period.
(b) To report on the matters in (a) above in accordance with the service auditor's findings.

3.3 Type 1 Report & Type 2 Report

Type 1 report is a report that comprises:	**Type 2 report is a report that comprises:**
(i) The service organization's description of its system; (ii) A written assertion by the service organization that, in all material respects, and based on suitable criteria: a. The description fairly presents the service organization's system as designed and implemented at the specified date; b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed as at the specified date; and	(i) The service organization's description of its system; (ii) A written assertion by the service organization that, in all material respects, and based on suitable criteria: a. The description fairly presents the service organization's system as designed and implemented throughout the specified period; b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed

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(iii) A service auditor's assurance report that conveys reasonable assurance about the matters referred to in (ii).	throughout the specified period; and c. The controls related to the control objectives stated in the service organization's description of its system operated effectively throughout the specified period; and (iii) A service auditor's assurance report that: - a. Conveys reasonable assurance about the matters in (ii) and b. Includes a description of the tests of controls and the results thereof.
Type 1 report is a report on the description and design of controls at a service organization whereas type 2 report is a report on the description, design and operating effectiveness of controls at a service organization.	

3.4 How such an Engagement is Proceeded with?

(1) **Compliance with ethical requirements:** The service auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to assurance engagements.

(2) **Determination of Management and those charged with governance and communication with them:** The service auditor shall inquire of request representations from, communicate with, or otherwise interact with the service organization wherever required. The service auditor shall determine the appropriate persons within the service organization's management or governance structure with whom to interact.

(3) **Acceptance and changes in terms of engagement:** Before, accepting such an engagement, it has to be ensured by service auditor that necessary capabilities and competence to carry out such engagement are possessed by him. It also needs to be ensured that the criteria to be applied by the service organization to prepare the description of its

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system will be suitable and available to user entities and their auditors and the scope of the engagement and the service organization's description of its system will not be so limited that they are unlikely to be useful to user entities and their auditors.

If the service organization requests a change in the scope of the engagement before the completion of the engagement, the service auditor shall be satisfied that there is a reasonable justification for the change.

(4) **Assessing of suitability of the Criteria:** The service auditor shall assess whether the service organization has used suitable criteria in preparing the description of its system, in evaluating whether controls are suitably designed, and, in the case of a type 2 reports, in evaluating whether controls are operating effectively.

(5) **Determination of Materiality:** When planning and performing the engagement, the service auditor shall consider materiality with respect to the fair presentation of the description, the suitability of the design of controls and, in the case of a type 2 report, the operating effectiveness of controls.

(6) **Obtaining an understanding of the Service organization's system:** The service Auditor shall obtain an understanding of the service organization's system, including controls that are included in the scope of engagement.

(7) **Obtaining evidence regarding the description:** The service auditor shall obtain and read the service organization's description of its system and evaluate whether those aspects of the description included in the scope of engagement are fairly presented.

(8) **Obtaining evidence regarding the design of controls:** The service auditor shall determine which of the controls at the service organization are necessary to achieve the control objectives stated in the service organization's description of its system and shall assess whether those controls were suitably designed.

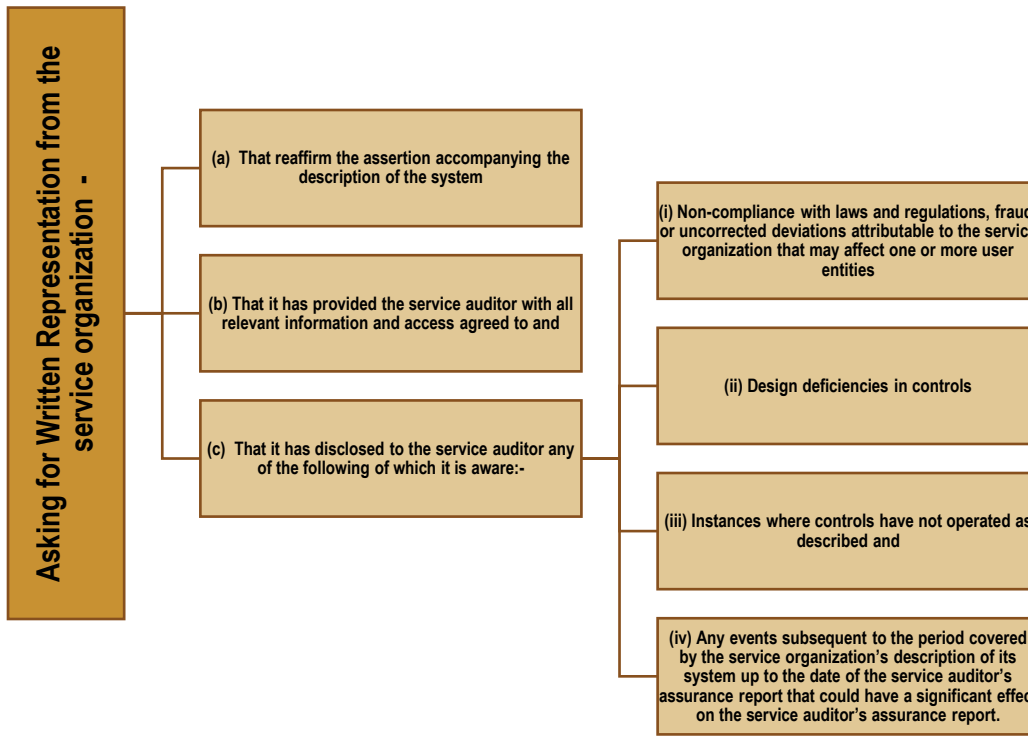
(9) **Obtaining evidence regarding operating effectiveness of controls:** When providing a type 2 report, the service auditor shall test those controls that the service auditor has determined are necessary to achieve the control objectives stated in the service organization's description of its system and assess their operating effectiveness throughout the period.

(10) **Understanding the internal audit function:** If the service organization has an internal audit function, the service auditor shall obtain an understanding of the nature of the responsibilities of the internal audit function and of the activities performed in order to determine whether the

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internal audit function is likely to be relevant to the engagement in order for the service auditor to use specific work of the internal auditors.

(11) Asking for Written Representations: The service auditor shall request the service organization to provide written representations: -



(12) Subsequent Events: The service auditor shall inquire whether the service organization is aware of any events subsequent to the period covered by the service organization's description of its system up to the date of the service auditor's assurance report that could have a significant effect on the service auditor's assurance report.

3.5 Reporting

The service auditor's assurance report shall include the following basic elements: -

(a)	A title that clearly indicates the report is an independent service auditor's assurance report.
(b)	An addressee.

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(c) Identification of:

(i) The service organization's description of its system, and the service organization's assertion, which includes the matters for a type 2 report, or for a type 1 report.

(ii) Those parts of the service organization's description of its system, if any, that are not covered by the service auditor's opinion.

(iii) If the description refers to the need for complementary user entity controls, a statement that the service auditor has not evaluated the suitability of design or operating effectiveness of complementary user entity controls, and that the control objectives stated in the service organization's description of its system can be achieved only if complementary user entity controls are suitably designed or operating effectively, along with the controls at the service organization.

(iv) If services are performed by a subservice organization, the nature of activities performed by the subservice organization as described in the service organization's description of its system.

(d) Identification of the criteria, and the party specifying the control objectives.

(e) A statement that the report and, in the case of a type 2 report, the description of tests of controls are intended only for user entities and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements.

(f) A statement that the service organization is responsible for: -

(i) Preparing the description of its system, and the accompanying assertion, including the completeness, accuracy and method of presentation of that description and that assertion;

(ii) Providing the services covered by the service organization's description of its system;

(iii) Stating the control objectives (where not identified by law or regulation, or another party, for example, a user group or a professional body) and

(iv) Designing and implementing controls to achieve the control objectives stated in the service organization's description of its system.

(g) A statement that the service auditor's responsibility is to express an opinion on the service organization's description, on the design of controls related to the control objectives stated in that description and, in the case of a type 2 report, on the operating effectiveness of those controls, based on the service auditor's procedures.

(h) A statement that the engagement was performed in accordance with SAE 3402, "Assurance Reports on Controls at a Service Organization," which requires that the

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service auditor comply with ethical requirements and plan and perform procedures to obtain reasonable assurance about whether, in all material respects, the service organization's description of its system is fairly presented and the controls are suitably designed and, in the case of a type 2 report, are operating effectively.

(i) A summary of the service auditor's procedures to obtain reasonable assurance and a statement of the service auditor's belief that the evidence obtained is sufficient and appropriate to provide a basis for the service auditor's opinion, and, in the case of a type 1 report, a statement that the service auditor has not performed any procedures regarding the operating effectiveness of controls and therefore no opinion is expressed thereon.

(j) A statement of the limitations of controls and, in the case of a type 2 report of the risk of projecting to future periods any evaluation of the operating effectiveness of controls.

(k) The service auditor's opinion, expressed in the positive form, on whether, in all material respects, based on suitable criteria:

(i) In the case of a type 2 report: - a. The description fairly presents the service organization's system that had been designed and implemented throughout the specified period; b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period; and c. The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the specified period.	(ii) In the case of a type 1 report: - a. The description fairly presents the service organization's system that had been designed and implemented as at the specified date; and b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed as at the specified date.

(l) The date of the service auditor's assurance report, which shall be no earlier than the date on which the service auditor has obtained sufficient appropriate evidence on which to base the opinion.

(m) Signature-The report should be signed by the practitioner.

(n) The place of signature – the report should name specific location, which is ordinarily the city where the report is signed.

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Additional matters requiring reporting in type 2 report: In the case of a type 2 report, the service auditor's assurance report shall include a separate section after the opinion, or an attachment, that describes the tests of controls that were performed and the results of those tests.

In describing the tests of controls, the service auditor shall clearly state which controls were tested, identify whether the items tested represent all or a selection of the items in the population, and indicate the nature of the tests in sufficient detail to enable user auditors to determine the effect of such tests on their risk assessments.

If deviations have been identified, the service auditor shall include the extent of testing performed that led to identification of the deviations (including the sample size where sampling has been used), and the number and nature of the deviations noted.

The service auditor shall report deviations even if, on the basis of tests performed, the service auditor has concluded that the related control objective was achieved.

Modified Opinions

If the service auditor concludes that			
(a) The service organization's description does not fairly present, in all material respects, the system as designed and implemented;	(b) The controls related to the control objectives stated in the description were not suitably designed, in all material respects;	(c) In the case of a type 2 report, the controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the service organization's description of its system were achieved, did not operate effectively, in all material respects; or	(d) The service auditor is unable to obtain sufficient appropriate evidence, the service auditor's opinion shall be modified, and the service auditor's assurance report shall contain a clear description of all the reasons for the modification.

3.6 Documentation

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

(a) The nature, timing, and extent of the procedures performed to comply with this SAE and applicable legal and regulatory requirements;

(b) The results of the procedures performed, and the evidence obtained; and

(c) Significant matters arising during the engagement, and the conclusions reached thereon and significant professional judgments made in reaching those conclusions.

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TEST YOUR UNDERSTANDING 2

Bansi Group is a leading institution running prestigious postgraduate courses in the field of management. Its financial statements are audited by an independent auditor. Before the start of this academic session, the Board of the institution had outsourced its entire process of inviting student applications, submission of applications, and collection of application fees including late fees and such matters to Easy Solutions Limited.

The auditors of Bansi Group want to be sure about the design and operating effectiveness of controls at Easy Solutions Limited. What should be the nature of the report to be provided by auditors of Easy Solutions Limited specifically for use by Bansi Group and its auditors in this regard in terms of SAE 3402?

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

SAE 3420 deals with reasonable assurance engagements undertaken by a practitioner to report on the responsible party's compilation of pro forma financial information included in a prospectus. It applies where such reporting is required by securities law or regulation of the security exchange in the jurisdiction in which the prospectus is to be issued or this reporting is generally accepted practice in such jurisdiction.

What is Pro forma financial information?

Pro forma financial information refers to financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration.

The Pro forma financial information is, normally, used in the offer documents to demonstrate the effect of a transaction on the financial statements of a company as if those transactions had occurred at an earlier date. The Pro forma financial information may take the form of the Statement of Profit and Loss and Balance Sheet to illustrate how the transactions might have affected the assets, liabilities and earnings of the Issuer. They also include notes in relation to the significant aspects of the transactions, assumptions used to prepare the Pro forma financial information, and the adjustments made.

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The purpose of pro forma financial information included in a prospectus is solely to illustrate the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration. This is achieved by applying pro forma adjustments to the unadjusted financial information. Pro forma financial information does not represent the entity's actual financial position, financial performance, or cash flows.

4.1 Objectives in Accordance with SAE 3420

The objectives of the practitioner in accordance with SAE 3420 are: -

(a) To obtain reasonable assurance about whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria and

(b) To report in accordance with the practitioner's findings.

4.2 Compilation of Pro forma financial information

The compilation of pro forma financial information involves the responsible party gathering, classifying, summarising and presenting financial information that illustrates the impact of a significant event or transaction on the unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at the selected date.

Steps involved in this process include:-
❖ Identifying the source of the unadjusted financial information to be used in compiling the pro forma financial information, and extracting the unadjusted financial information from that source;
❖ Making pro forma adjustments to the unadjusted financial information for the purpose for which the pro forma financial information is presented; and
❖ Presenting the resulting pro forma financial information with accompanying disclosures.

4.3 Nature of the Practitioner's Responsibility

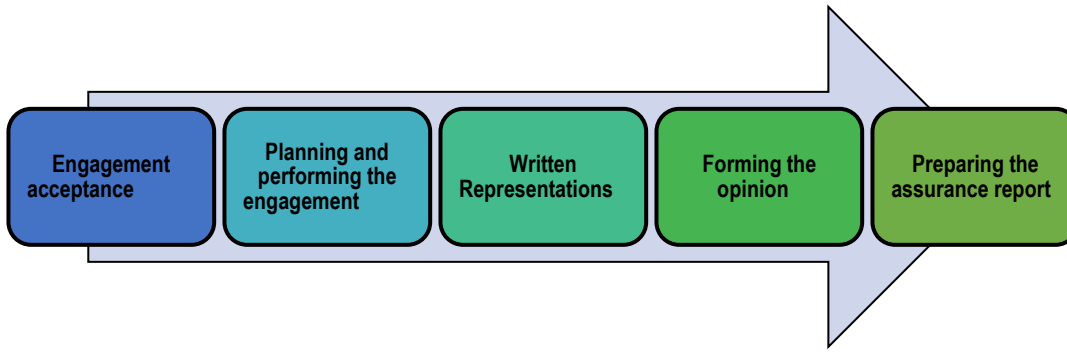
In such an engagement performed under this SAE, the practitioner has no responsibility to compile the pro forma financial information for the entity. Such responsibility rests with the responsible party. The practitioner's sole responsibility is to report on whether the pro forma financial information has

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been compiled, in all material respects, by the responsible party on the basis of the applicable criteria.

It is a reasonable assurance engagement to report on the compilation of pro forma financial information involving performing the procedures to assess whether the applicable criteria used by the responsible party in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction.

4.4 Steps involved in such an Engagement



4.4.1 Engagement Acceptance

Before agreeing to accept an engagement to report on whether pro forma financial information included in a prospectus has been compiled, in all material respects, on the basis of the applicable criteria, the practitioner shall consider matters stated below. "Applicable criteria" are criteria used by the responsible party when compiling the pro forma financial information. Criteria may be established by an authorized or recognized standard-setting organization or by law or regulation. Where established criteria do not exist, they will be developed by the responsible party.

(a) Determine that the practitioner has the capabilities and competence to perform the engagement;

(b) On the basis of a preliminary knowledge of the engagement circumstances and discussion with the responsible party, determine that the applicable criteria are suitable and that it is unlikely that the pro forma financial information will be misleading for the purpose for which it is intended;

(c) Evaluate the wording of the opinion prescribed by the relevant law or regulation, if any, to determine that the practitioner will likely be able to express the opinion so prescribed based on performing the procedures specified in this SAE;

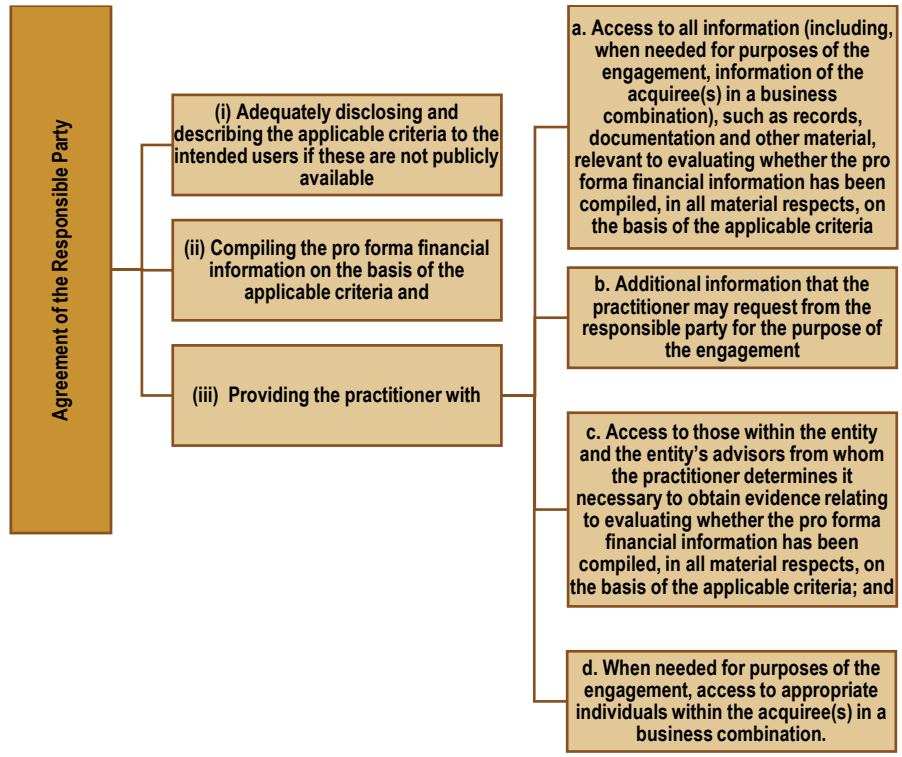
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(d) Where the sources from which the unadjusted financial information and any acquiree or divestee financial information have been extracted have been audited or reviewed and a modified audit opinion or review conclusion has been expressed, or the report contains an Emphasis of Matter paragraph, consider whether or not the relevant law or regulation permits the use of, or reference in the practitioner's report to, the modified audit opinion or review conclusion or the report containing the Emphasis of Matter paragraph with respect to such sources;

(e) If the entity's historical financial information has never been audited or reviewed, consider whether the practitioner can obtain a sufficient understanding of the entity and its accounting and financial reporting practices to perform the engagement;

(f) If the event or transaction includes an acquisition and the acquiree's historical financial information has never been audited or reviewed, consider whether the practitioner can obtain a sufficient understanding of the acquiree and its accounting and financial reporting practices to perform the engagement; and

(g) Obtain the agreement of the responsible party that it acknowledges and understands its responsibility for:



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4.4.2 Planning and Performing the Engagement

- The practitioner shall assess whether the applicable criteria are suitable, as required by the Framework for Assurance Engagements.
- When planning and performing the engagement, the practitioner shall consider materiality with respect to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria.
- An understanding of how the responsible party has compiled the pro forma financial Information and other engagement circumstances.
- The practitioner shall obtain evidence about the appropriateness of the source from which the unadjusted financial information has been extracted.
- If there is no audit or review report on the source from which the unadjusted financial information has been extracted, the practitioner shall perform procedures to be satisfied that the source is appropriate.
- The practitioner shall determine whether the responsible party has appropriately extracted the unadjusted financial information from the source.
- The practitioner shall obtain evidence about the appropriateness of the pro forma adjustments.

In relation to unadjusted financial information, Pro forma adjustments include:
(a) Adjustments to unadjusted financial information that illustrate the impact of a significant event or transaction as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration and
(b) Adjustments to unadjusted financial information that are necessary for the pro forma financial information to be compiled on a basis consistent with the applicable financial reporting framework of the reporting entity and its accounting policies under that framework.

- The practitioner shall evaluate the presentation of pro forma financial information.
- The practitioner shall read the other information included in the Prospectus containing the pro forma financial information to identify material inconsistencies, if any, with pro forma financial information.

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4.4.3 Written Representations

The practitioner shall request written representations from the responsible party that:-

(a) In compiling the pro forma financial information, the responsible party has identified all appropriate pro forma adjustments necessary to illustrate the impact of the event or transaction at the date or for the period of the illustration and

(b) The pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria.

4.4.4 Opinion

Unmodified Opinion

The practitioner shall express an unmodified opinion when the practitioner concludes that the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria.

Modified Opinion

(a) Where the relevant law or regulation precludes publication of a prospectus that contains a modified opinion with regard to whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria and the practitioner concludes that a modified opinion is nevertheless appropriate in accordance with the Framework for Assurance Engagements, the practitioner shall discuss the matter with the responsible party.

If the responsible party does not agree to make the necessary changes, the practitioner shall

- Withdraw from the engagement or
- Consider seeking legal advice.

(b) Where the relevant law or regulation may not preclude publication of a prospectus that contains a modified opinion with regard to whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria and the practitioner determines that a modified opinion is appropriate in accordance with the Framework for Assurance Engagements, the practitioner shall apply the requirements in the Framework for Assurance Engagements regarding modified opinions.

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Emphasis of Matter Paragraph

In some circumstances, the practitioner may consider it necessary to draw the user's attention to a matter presented or disclosed in the pro forma financial information or the accompanying explanatory notes. This would be the case when, in the practitioner's opinion, the matter is of such importance that it is fundamental to the user's understanding of whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria.

In such circumstances, the practitioner shall include an Emphasis of Matter paragraph in the practitioner's report provided that the practitioner has obtained sufficient appropriate evidence that the matter does not affect whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria. Such a paragraph shall refer only to information presented or disclosed in the pro forma financial Information or the accompanying explanatory notes.

4.4.5 Preparing the Assurance Report

The practitioner's report shall include the following basic elements: -

Basic elements of Assurance Report	
(a)	A title that clearly indicates that the report is an independent assurance report;
(b)	An addressee(s), as agreed in the terms of engagement;
(c)	**Introductory paragraphs that identify: -**
	(i) The pro forma financial information;
	(ii) The source from which the unadjusted financial information has been extracted and whether or not an audit or review report on such a source has been published;
	(iii) The period covered by, or the date of, the pro forma financial information; and
	(iv) A reference to the applicable criteria on the basis of which the responsible party has performed the compilation of the pro forma financial information, and the source of the criteria;
(d)	A statement that the responsible party is responsible for compiling the pro forma financial information on the basis of the applicable criteria;

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(e) A description of the practitioner's responsibilities, including statements that: -

(i) The practitioner's responsibility is to express an opinion about whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria;

(ii) For purposes of this engagement, the practitioner is not responsible for updating or reissuing any reports or opinions on any historical financial information used in compiling the pro forma financial information, nor has the practitioner, in the course of this engagement, performed an audit or review of the financial information used in compiling the pro forma financial information; and

(iii) The purpose of pro forma financial information included in a prospectus is solely to illustrate the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration. Accordingly, the practitioner does not provide any assurance that the actual outcome of the event or transaction at that date would have been as presented;

(f) A statement that the engagement was performed in accordance with SAE 3420, '*Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus'*, which requires that the practitioner comply with ethical requirements and plan and perform procedures to obtain reasonable assurance about whether the responsible party has compiled, in all material respects, the pro forma financial information on the basis of the applicable criteria;

(g) Statements that: -

(i) A reasonable assurance engagement to report on whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria involves performing procedures to assess whether the applicable criteria used by the responsible party in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction and to obtain sufficient appropriate evidence about whether: -

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The related pro forma adjustments give appropriate effect to those criteria; and

The pro forma financial information reflects the proper application of those adjustments to the unadjusted financial information

(ii) The procedures selected depend on the practitioner's judgment, having regard to the practitioner's understanding of the nature of the entity, the event or transaction in respect of which the pro forma financial information has been compiled, and other relevant engagement circumstances; and

(iii) The engagement also involves evaluating the overall presentation of the pro forma financial information;

(h) Unless otherwise required by law or regulation, the practitioner's opinion using one of the following phrases, which are regarded as being equivalent: -

(i) The pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria; or

(ii) The pro forma financial information has been properly compiled on the basis stated;

(i) The practitioner's signature;

(j) The date of the report; and

(k) The place of signature.

4.5 Documentation

As in case of all assurance engagements, documentation has to be ensured by the practitioner while performing engagement under SAE 3420.

TEST YOUR UNDERSTANDING 3

The management of S Ltd. requests you to accept an engagement to report on the compilation of pro forma financial information to be included in the prospectus. In light of SAE 3420, what factors will you consider regarding the company acknowledging and understanding its responsibility in this matter before accepting engagement?

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Integrated Case Scenario

Below is given draft text of the *"Report on Examination of Prospective Financial Information"* of Top Edge Limited in relation to the company's upcoming project prepared by a staff member in a CA firm *unfamiliar with drafting such reports. The report has been drafted in a casual manner and may consist of omissions and errors.*

Report on Examination of Prospective Financial Information

To

The Board of Directors

Top Edge Limited

We have examined the projection of the *upcoming project to come up at* Ratnagiri of Top Edge Limited for the period from April 2024 to March 2030 as given in the Prospective Financial Information from page 1 to 250 in accordance with ***Standard on Assurance Engagement 3400, "The Examination of Prospective Financial Information",*** issued by the Institute of Chartered Accountants of India.

The preparation and presentation of the projection is the responsibility of the Management and has been approved by the Board of Directors of the company.

Our responsibility is to examine the evidence supporting the assumptions (excluding the hypothetical assumption) and other information in the prospective financial information.

The projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur.

We have carried out our examination of the prospective financial information thoroughly.

Further, in our opinion the projection is properly prepared on the basis of the assumptions as set out in Note 1 to 50 to the Prospective Financial Information and on a consistent basis with the historical financial statements, using appropriate accounting principles. Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

For PCK & Co.

Chartered Accountants

Signature

Designation

Membership number

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Based on your knowledge and description of the case, answer the following questions: -

1. Whose responsibility is to list out assumptions underlying prospective financial information?

(a) Professional Accountant issuing report on prospective financial information.

(b) Auditor of Company issuing report on prospective financial information.

(c) Management of company.

(d) Banker of company.

2. Which of the following statements is most appropriate regarding "use of prospective financial information" to be included in such a report?

(a) Intended use of projection is required to be disclosed. It is further necessary to caution the users regarding inappropriateness of projections for other purposes.

(b) It is discretionary to state intended use of projection in such a report.

(c) Intended use of projection is required to be disclosed. It is not necessary to caution the users regarding inappropriateness of projections for other purposes.

(d) It is prerogative of management to use report in the manner it deems fit.

3. Which of the following statements is most appropriate regarding the examination of prospective financial information by a Chartered accountant in accordance with SAE 3400?

(a) Accuracy of projections is vouched for based upon performing procedures thoroughly.

(b) Projections can go haywire; It depends upon the professional judgment of the Chartered Accountant to vouch for the accuracy of projections.

(c) Accuracy of projections is not at all vouched for in an assurance report on prospective financial information.

(d) The matter of accuracy of projections or otherwise is not domain of such an examination. Therefore, there is no reporting requirement under SAE 3400.

4. Which of the following statements is most appropriate regarding UDIN in context of examination of prospective financial information by a Chartered Accountant?

(a) It is mandatory to state UDIN in such type of reports.

(b) It is desirable to state UDIN in such type of reports.

(c) It is not required to state UDIN in such type of reports as it is not an audit engagement.

(d) It is not required to state UDIN in such type of reports as it is not an engagement related to historical financial information.

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Key Takeaways

- An assurance engagement may relate to the examination of subject matters other than an examination of financial statements prepared on the basis of "historical financial information". In such types of assurance engagements, the examination may relate to prospective financial information or to providing assurance regarding non-financial matters like the design and operation of internal control in an entity. Standards on Assurance Engagements deal with the responsibilities of professional accountants in assurance engagements dealing with such matters.
- "Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It can be in the form of a forecast, a projection, or a combination of both.
- SAE 3400 provides guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions.
- Service organization refers to a third-party organization (or segment of a third-party organization) that provides services to user entities that are likely to be relevant to user entities' internal control as it relates to financial reporting.
- Controls related to a service organization's operations and compliance objectives may be relevant to a user entity's internal control as it relates to financial reporting.
- SAE 3402 deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities internal control as it relates to financial reporting.
- Pro forma financial information refers to financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration.
- The Pro forma financial information is, normally, used in the offer documents to demonstrate the effect of a transaction on the financial statements of a company as if those transactions had occurred at an earlier date.

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- SAE 3420 deals with reasonable assurance engagements undertaken by a practitioner to report on the responsible party's compilation of pro forma financial information included in a prospectus.
- SAE 3420 applies where such reporting is required by securities law or regulation of the security exchange in the jurisdiction in which the prospectus is to be issued or this reporting is generally accepted practice in such jurisdiction.

TEST YOUR KNOWLEDGE

Theoretical Questions

1 *Ayurda Ltd. is a fast-growing and award-winning SaaS software company which is headquartered in Mumbai. It also has offices in the UK and provides cloud-based professional services automation (PSA) software solutions to professional services organizations around the world. They want to engage you to provide an assurance report for one of its major clients over the controls it operates as a service organisation. Can you provide such an assurance report?*

2. *Discuss the significance of Pro forma financial information included in prospectus of a company.*

3. *Discuss the term "Pro forma adjustment" under SAE 3420.*

4. *Discuss how a Chartered Accountant can be associated with prospective financial information without violating relevant provisions of the Chartered Accountants Act, 1949.*

5. ***STAR Limited has outsourced its payroll processing functions to a service organization - Little Solutions Private Limited. Little Solutions Private Limited is responsible for accurate preparation of payrolls and timely remittance of statutory dues to the government authorities on behalf of the company. Little Solution Private Limited's controls related to timely remittance of payroll deductions to government authorities are relevant to the company as late remittances could result in interest and penalties resulting in liabilities for the company.***

   The auditors of STAR Limited want to be sure about description, design and operating effectiveness of controls at Little Solutions throughout the year. In this regard, they require an assurance report from auditors of Little Solutions Private Limited.

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(a) Why the auditors of STAR Limited require an assurance report from the auditors of Little Solutions Private Limited? Which Engagement and Quality Control Standard casts such kind of responsibility upon the auditor?

(b) Which type of report should be provided by the auditors of Little Solutions? Justify with reasons.

(c) State matters on which opinion is to be provided by the auditors of Little Solutions.

6. *Mr. Vineet, an auditor, has been approached by Qub Ltd. to examine the prospective financial information of the company. What factors should an auditor consider before accepting an engagement to examine prospective financial information, and under what conditions should the auditor decline or withdraw from such an engagement? Additionally, what steps should be taken to formalize the terms of the engagement?*

7. *SAE 3400 explains that prospective financial information can take the form of a forecast, a projection, or a combination of both. In this context, how do you differentiate a forecast from a projection? Also provide an example. Additionally, explain the nature of assurance provided by the practitioner regarding prospective financial information in accordance with SAE 3400.*

8. *You are engaged by M/s Viva Limited to examine and report on prospective financial information which the management of the company has prepared for presentation at an Investor meet program organized by a State Government to attract investment in their state.*

   The company in its vision document described various plans and proposals of the company with projected financial goals and means to achieve the same and various benefits accruing to the economic development of the State. What important matters will be considered by you while determining the nature, timing, and extent of examination procedure to be applied in the review of the same?

Answers to Test Your Understanding

1. In such types of engagements, it is the duty of a professional accountant to see that prospective financial information is based on a consistent basis with historical financial statements using appropriate accounting principles.

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In the case of a company, historical financial statements are prepared considering the requirements of the Companies Act, and depreciation is calculated accordingly. However, in the given situation, depreciation has been calculated in accordance with the Income-tax Act,1961 which is not consistent with historical financial statements. Therefore, it is not proper.

The fact that the projection has not been prepared on a consistent basis with the historical financial statements, using appropriate accounting principles needs to be stated.

Further, when presentation and disclosure are not adequate, a qualified or adverse opinion should be given or withdrawal from engagement should be made as appropriate.

2. In such a case, the auditors of Bansi Group want to be sure about the design and operating effectiveness of controls at the organization which is providing services to their client. Type 2 report is a report on the description, design and operating effectiveness of controls operating at the service organization. Auditors of Easy Solutions Limited should provide such a report giving assurance on these matters. It should also include details of tests of controls performed and details of deviations, if any.

3. The company's responsibility has to be acknowledged for the following matters:-

(i) Adequately disclosing and describing the applicable criteria to the intended users if these are not publicly available;

(ii) Compiling the pro forma financial information on the basis of the applicable criteria; and

(iii) Providing the practitioner with:-

a. Access to all information (including, when needed for purposes of the engagement, information of the acquiree(s) in a business combination), such as records, documentation and other material, relevant to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria;

b. Additional information that the practitioner may request from the responsible party for the purpose of the engagement;

c. Access to those within the entity and the entity's advisors from whom the practitioner determines it necessary to obtain evidence relating to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria; and

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d. When needed for purposes of the engagement, access to appropriate individuals within the acquiree(s) in a business combination.

Answers to Integrated Case Scenario

1. (c) **2.** (a) **3.** (c) **4.** (a)

Hints /Answers to Theoretical Questions

1. Assurance report can be provided under SAE 3402. Refer to Para 3.

2. Refer to Para 4.

3. Refer to Para 4.4.2.

4. Refer to Para 2.3.

5. ***When the user entity uses the services of a service organisation, objectives of auditor of user entity are:***

(a) ***To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and***

(b) ***To design and perform audit procedures responsive to those risks.***

Therefore, it is in line with the above requirements that auditors of STAR Limited require an assurance report from auditors of Little Solutions Private Limited. SA 402 casts such responsibility on user auditors.

In accordance with requirements of SAE 3402, auditors of Little Solutions Private Limited should provide a type 2 report to auditors of STAR Limited. As auditors of STAR Limited want to be sure about description, design and operating effectiveness of controls at Little Solutions Pvt. Ltd. throughout the year and type 2 report deals with such matters, type 2 report should be provided by the auditors of the Little Solutions Pvt. Ltd. Type 2 report is a report on the description, design and operating effectiveness of controls at a service organization whereas type 1 report is a report on the description and design of controls at a service organization.

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(c) The opinion of auditors of Little Solutions Pvt. Ltd. would state whether, in all material respects, based on suitable criteria: -

- *The description fairly presents the service organization's system that had been designed and implemented throughout the specified period;*
- *The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period and*
- *The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the specified period.*

6. Before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:

- *The intended use of the information;*
- *Whether the information will be for general or limited distribution;*
- *The nature of the assumptions, that is, whether they are best estimates or hypothetical assumptions;*
- *The elements to be included in the information; and*
- *The period covered by the information.*

The auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use. The auditor should consider the extent to which reliance on the entity's historical financial information is justified.

To formalize the terms of the engagement, it is essential to agree on the terms with the client by sending an engagement letter, like in other engagements.

7. Prospective financial information can be in the form of a forecast, a projection, or a combination of both, for example, a one year forecast plus a five- year projection.

"Forecast" means prospective financial information prepared on the basis of:

- *Assumptions as to future events which management expects to take place and*
- *The actions management expects to take as of the date the information is prepared (best-estimate assumptions- an assumption that reflects anticipated experience with no provision for risk of adverse deviation).*

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Example- In present market conditions, supply availability, historical buying patterns and seasonal trends, the CFO of X Ltd. expects sales to increase by 5% over the next quarter. Therefore, a 5% sales increase is his financial forecast for the period.

"Projection" means prospective financial information prepared on the basis of:

- ***Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or***
- ***A mixture of best-estimate and hypothetical assumptions (imagined or suggested)***

Example- X Ltd. may project a course of action to take when one or more hypothetical situations arise, such as creating a new product to meet the demand of expected market growth. As a result of assuming the possibility of different events occurring, financial projections typically serve as an outline for evaluating the desired outcomes X Ltd. expects to see, including its financial, cash flow and operational outcomes.

Prospective financial information relates to events and actions that have not yet occurred and might not occur. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented and, therefore, speculative in nature, as distinct from the evidence ordinarily available in the examination of historical financial information. Therefore, an opinion as to whether the results shown in the prospective financial information will be achieved cannot be expressed.

8. Refer Para 2.7.

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CHAPTER 12

DIGITAL AUDITING AND ASSURANCE



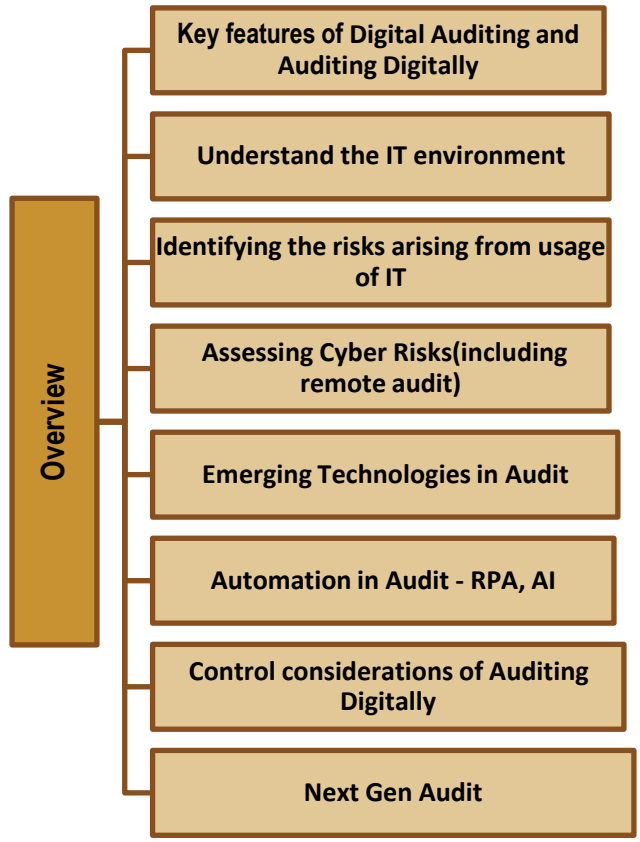
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the key features of digital auditing and auditing digitally.
- Understand IT environment and its complexity.
- Know how to identify the IT dependencies impacting the audit.
- Gain the knowledge of how to identify IT related risks and controls that exists in an automated environment.
- Learn key considerations to assess the cyber risks and remote audit.
- Learn the control objectives that auditor should consider in performing IT audit.
- Know the types and tools available to perform digital audit.
- Learn the usage of data analytics in assessing and analysing the key data.

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CHAPTER OVERVIEW



CA M woke up on a relaxing Sunday morning and read a report in his favourite business newspaper about a new initiative by ICAI and the Indian Banks Association to develop a balance confirmation portal. The report mentioned that this platform would allow auditors to get direct, authenticated balance confirmations from banks. "Auditing Digitally improves efficiency and audit quality," he thought. He realized that besides promoting transparency, such initiatives could also increase efficiency and reduce costs. But what does auditing digitally precisely signify?

Auditing digitally is using the advancements in technology for conducting an effective and efficient audit. With a rapidly growing IT environment, adaptation of technology in auditing practices has become essential. Use of data analytics, artificial intelligence and robotics

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process automation can go a long way in improving quality of audit. Data analytics involves analysing large sets of data to find actionable insights, trends and drawing of conclusions for informed decision making. Currently, audit approach is based upon sampling. This is undergoing transformation, and process is likely to be accelerated in times to come.

Robotics Process Automation (RPA) involves use of programs to perform repetitive tasks. Such computer software is useful in many business processes like payroll generation, order processing, invoice processing and a host of other business functions involving repetitive tasks. RPA can help auditor in automating classification for risk assessment process with the help of bots. Bots can even be used to prepare report on automated controls configured on ERP!

He was also reading an article as to how disruptive blockchain technology could be as internet was in 90s and its impact on auditing profession. Blockchain as a technology takes the connectivity of the internet one step further. It offers users the internet of value. Blockchain is a shared immutable ledger and is replicated across several systems in almost real time. It is put together in encrypted blocks. It was further opined that Blockchain will do for transactions what the Internet did for information.

With emerging technologies like Blockchain and its combination with data analytics, big data and robotics, it is going to be possible to audit all of information. Since blockchain allows access to transaction history, it is going to revolutionize audit approach and work. The information stored on a blockchain is likely to be available to the auditor as soon as it is generated. How exciting outcomes of such a scenario could be? The dependency on the client to provide information may become redundant in coming future. Another important application of it is use of *"smart contracts"* which can be embedded in a blockchain to automate business processes. It is likely to lead to more emphasis on "tests of controls" than "tests on details".

His discerning mind was quickly realizing that with advancements in technology, cyber-attacks are also bound to grow. It is not an IT issue alone. It affects an entity's reputation and theft of sensitive information like intellectual property rights, personally identifiable information and disruptions in automated operations. Auditor should consider whether cyber risk represents a risk of material misstatement to the financial statement as part of the audit risk assessment activities. Focus should be on understanding the cyber risks affecting the entity and the actions being taken to address these risks.

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1. DIGITAL AUDIT

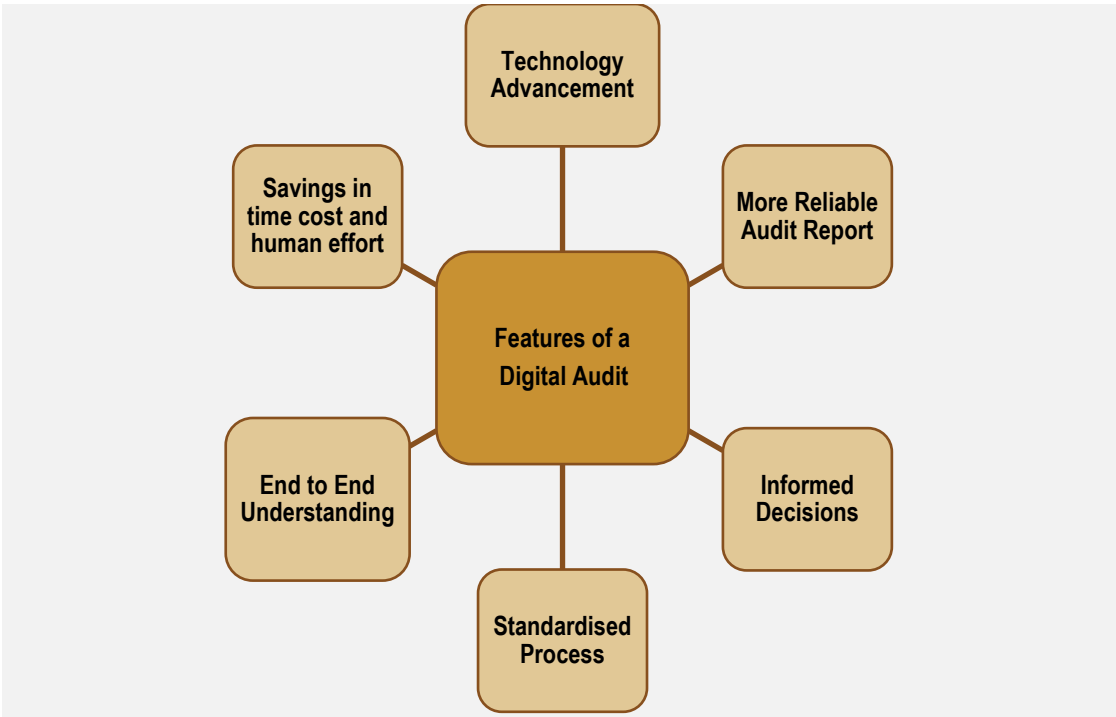
1.1 What is a Digital Audit?

Digital Audit is placing assurance on the effectiveness of the IT systems implemented in an organization. Technology is becoming an integral part of day-to-day business operations. It is essential that organizations review their technology-related controls to identify gaps and risks for continuous improvement and to ensure regulatory compliance. A strong controls and security position will allow organizations to build trust with their stakeholders.

1.2 Key Features of a Digital Audit

- Digital audit encourages the auditee to embrace the latest **technological advancements** and provides **confidence** to auditee to stay updated in a constantly evolving environment.
- A digital audit improves the quality of opinion. This consequently leads to a **more reliable audit report**
- Digital Audit leads to **savings in time, cost and human effort** which can be utilized towards more productive tasks. Many of today's digitally enabled processes can be orchestrated to operate autonomously 24x7, driving real-time transactions.
- Digital Audit allows to **standardize processes** and allow controls to be implemented to mitigate risk.
- The digital audit will help organisation gain a more **comprehensive overview** of end-to-end processes and how technologies are utilized, controlled and optimized against standards set.
- The digital audit will help create a **future for a digital strategy** and paves way for adopting new technologies such as AI and Robotic, usage of analytics and automation.
- It can help the auditee to make **informed decisions**.

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1.3 Advantages of Digital Audit

(i) **Enhanced Effectiveness & Efficiency:** Increased efficiency is one of the key benefits of digital audit. With the use of tools and automation techniques, auditees can standardize the processes, and routine tasks can be automated like automating a reconciliation process that previously involved hours increase efficiency and saves time and costs.

(ii) **Better Audit Quality:** Technology can correctly evaluate massive volumes of data quickly. This can assist auditors in determining the areas that require more testing, lowering the chance that serious misstatements or other problems would go unnoticed.

(iii) **Lower Costs:** By automating processes that were previously done manually, technology can assist with the cost of auditing. This may shorten the time needed to complete an audit, which may lower the audit's overall cost.

(iv) **Better Analytics:** Improved analytics capabilities can aid management and auditors in seeing trends and patterns that may be challenging to spot manually. For instance, AI can examine a lot of financial data to spot possible fraud, which is hard for auditors to spot manually.

(v) **Improved Risk Assessment:** Creating a number of automations to assist with the audit process and streamlined testing improves the risk assessment procedure. Management and

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auditors put their testing efforts on sites with a higher risk of material misstatement and make informed decisions.



1.4 Consideration and Challenges of Digital Audit:

Some considerations that organization should keep in mind while using digital techniques & automation are given as under:

Know what **business benefits** the organization wants to achieve with automation	Think **people first** and do not underestimate **change is difficult**	Target the **right processes** – this is a key for successful automation.
Automation is not a stand-alone solution and should be part of **a broader digitalization strategy.**	Ensure the **process works** and it is standardised before automating. Bots do not easily adapt to process change	Automation introduces new challenges for organization. Don't forget about **governance and data security** in **the risk framework.**

As auditors will obtain an understanding of management's implementation and oversight of new technologies, they also will perform procedures to understand the changes to the company's

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business, including any changes to the information technology environment. Areas of focus could include understanding of the following:

- New activities or changes to existing processes due to new technology (e.g., new revenue streams, changes in the roles and responsibilities of entity personnel, automation of manual tasks, changes in staffing levels that affect an entity's internal control environment)
- Changes in the way the entity's systems are developed and maintained and whether these changes introduce new risks and require new controls to respond to those risks
- The impact the new technology as how the organization obtains or generates and uses relevant, quality information to support the functioning of internal control.

2. AUDITING DIGITALLY

2.1 What is the Concept of Auditing Digitally?

Auditing Digitally is using advancements in technology for conducting an effective and efficient audit. With a rapidly growing IT environment it is essential to adapt technology in auditing practices.



Using Sampling Tools for selection of a sample size from a population based on materiality or using Bot for analysis of statutory payments compliance as part of an audit assignment.

It is time to digitize the way an audit is delivered through automation and innovation. There are new technologies to help *capture* data, *automate* procedures, *analyse* information and *focus* on the real risks of the client. The opportunity is in understanding how technology can help and then applying it to the auditing challenges.

Expectations from an Auditor

Audit teams need to **involve the experts** on different software applications and technologies. Having the right level of expertise of new technology (such as RPA, AI, blockchain technology allows auditors to provide the highest quality of audit. Investment in digitally upskilling the people is the real secret to quality technology audit. Investment in technology across the profession has largely been focused on developing and using tools to **automate and enhance existing processes**, such as data analytics and collaboration and sharing tools, which help to drive quality in audits today. While this will remain core to the role of technology in the audit, there are many opportunities where more advanced technologies such as AI and drones could have an even bigger impact. Such technologies may also play a role in **evolving the scope of the audit** (e.g., in using data analytics and machine learning to help identify fraud).

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A manager on a weekly basis performs a manual control to review if vendor master additions and changes in the system are done post appropriate approvals.

This control can be tested and reperformed by the auditor using RPA technology – BOTs can login into the system and generate the report and write the output to an Excel file. Based on the population the BOT will select the samples of changes to be tested. Further BOT will pull the correct file with approved changes from SharePoint. Then it will perform the testing wherein it will populate the details of approvals (date, approved by) and identify if changes made without approvals. Lastly BOT will summarise the results for all the selected samples in an excel file. The auditor will then review the final results file to check if there are any exceptions (changes made without approvals) noted in the selected samples.

Due to the usage of BOT manual intervention has been reduced, more accurate results are populated, it results in saving auditors time as well and exceptions highlighted can be readily reviewed.

2.2 Key Features or Advantages of Auditing Digitally

Following are key features or advantages of Auditing Digitally:

(i) **Improved Quality of Audits:** The impact on quality is evident, through automation, data analytics techniques we can easily move from sample auditing to full population of transactions being reviewed or re-performed. This ultimately free up time for audit teams to analyses the information and better understand the business they audit. Technology requires an element of upfront investment, and it can be challenging to implement with regards to resources and people, but the value once it is up and running is undeniable.

(ii) **Decreasing human dependency**: Using technology minimizes the manual intervention which ultimately results in reducing the risk of manual errors. Technology helps in streamlining the process of testing for auditors which decreases the errors which occur from the judgement of different individuals.

(iii) **Increases Transparency**: With technological advancement transparency has been increased. New ERPs and tools have audit trail feature available to trace the transaction end to end. It helps the management or auditors to review the details like the date on which any change is made, who made the change, what has been changed, all such details are captured and can be used while performing audit.

(iv) **Automation and Ease:** Automating tasks like recording work in repositories, extracting data and sampling have improved the quality of audit and reduced the manual error. Using

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dashboards (e.g., Power BI) for reporting helps in understanding the position and helps the auditor to form his opinion.

(v) **Improved Efficiency:** What used to take weeks to learn and programme using deep experts, is now easily available to auditors after some simple training and digital upskilling. The result may be increased efficiency and fewer errors, but the benefits are wider reaching and personal. This also results in improved retention of talent and confidence.

(vi) **Better Risk Assessment:** With usage of automation and technology in audit, auditor may focus on the real challenges and assess the potential risk precisely. It gives time to auditors to focus on the bigger picture rather than being involved with repetitive tasks. Dashboards, visual presentations and other tools help in understanding where the risk lies and what all areas need more attention.



2.3 Considerations in Auditing Digitally

While all industry sectors are affected by the emergence of new technologies it is important to remember that the auditor's needs are unique. There are few questions it is important to ask and answer – at all stages of tech journey:

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2.3.1 What problems are you trying to solve?

Continuously evaluate the emerging technologies and latest tools to see what can benefit the audit. Think about what would make your audit easier or better and how you will measure the return on your investment.

2.3.2 Which technology can help you?

There are a number of tools available and many vendors and start-ups using data acquisition, manipulation and visualization tools. Consider how comfortably these solutions will integrate into your current processes and flag any potential implementation issues early on.

2.3.3 How will you upskill your people to make best use of the technology available?

Technology is only as good as the people using it. Training and development are critical to ensure teams understand how and why they are using the technology. Reluctance to change is obvious, however continuous training helps them to get better.

2.3.4 Range of automated solutions:

There is a range of automation solutions, from low to high sophistication, which helps to standardize the repeatable tasks and optimize the efforts resulting in doing better. Some of the techinques are using robotics and automation for data gathering activities, use of data analytics for planning and budgetting and reporting by dashboards.

Macros and Scripts	Business Process Automation (BPA)	Robotic Process Automation (RPA)	Intelligent Process Automation (IPA)
Rules-based automation within a specific application	Reengineering existing business processes e.g. workflows	Automating labour-intensive, repetitive activities across multiple systems and interfaces	• Combining RPA with artificial intelligence technologies to identify patterns, learn over time, and optimize workflows

3. UNDERSTAND THE IT ENVIRONMENT

- Understanding the ways in which the entity relies upon IT and how the IT environment is set up to support the business. This allows the auditor to better understand where risks might arise from the entity's use of IT (required as per SA 315).

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- Understanding how IT is used by the entity helps in identifying controls over the entity's IT processes.
- Assessing the complexity of the IT environment helps the teams consider whether to involve IT specialists or experts in the planning and/or execution of the audit, including initial consideration of whether to include specialists in the complexity assessment.



The auditor's understanding of the automated environment should include the following:

- The applications that are being used by the company.
- Details of the IT infrastructure components for each of the application.
- The organization structure and governance.
- The policies, procedures and processes followed.
- Extent of IT integration, use of service organizations.
- IT risks and controls.

The illustration below is an example of how an auditor can document details of an automated environment:

Application	Used for	Database	Operating System	Network	Server and Storage
SAP ECC/ HANA	Integrated application software	Oracle 19c	HP-UX	LAN, WAN	HP Server and NAS
REVS	Front Desk, Guest Reservations	MS-SQL Server 2018	Windows 2016 Server	In-house developed	HP Server Internal HDD
KOTS	Restaurant and Kitchen Orders	MS-SQL Server 2018	Windows 2016 Server	In-house developed	HP Server Internal HDD
BILLSYS	Billing	Oracle 12c	Windows 2016 Server	Packaged Software	HP Server Internal HDD

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3.1 Key Areas for an Auditor to Understand IT Environment

Key Areas for an Auditor to Understand IT Environment are as follows:

1. **Understand the flow of transaction:** The auditor's understanding of the IT environment may focus on identifying and understanding the nature and number of the specific IT applications and other aspects of the IT environment that are relevant to the flows of transactions and processing of information in the information system. Changes in the flow of transactions, or information within the information system may result from program changes to IT applications, or direct changes to data in databases involved in processing or storing those transactions or information.

2. **Identification of Significant Systems:** The auditor may identify the IT applications and supporting IT infrastructure concurrently with the auditor's understanding of how information relating to significant classes of transactions, account balances and disclosures flows into, through and out the entity's information system.

3. **Identification of Manual and Automated Controls:** An entity's system of internal control contains manual elements and automated elements (i.e., manual and automated controls and other resources used in the entity's system of internal control). An entity's mix of manual and automated elements varies with the nature and complexity of the entity's use of IT. The characteristics of manual or automated elements are relevant to the auditor's identification and assessment of the risks of material misstatement.

4. **Identification of the technologies used:** The need to understand the emerging technologies implemented and the role they play in the entity's information processing or other financial reporting activities and consider whether there are risks arising from their use.

   Given the potential complexities of these technologies, there is an increased likelihood that the engagement team may decide to engage specialists and/or auditor's experts to help understand whether and how their use impacts the entity's financial reporting processes and may give rise to risks from the use of IT.

   Some examples of emerging technologies are:

   - Blockchain, including cryptocurrency businesses (e.g., token issuers, custodial services, exchanges, miners, investors)
   - Robotics
   - Artificial Intelligence

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- Internet of Things
- Biometrics
- Drone

5. **Assessing the complexity of the IT environment:** Not all applications of the IT environment have the same level of complexity. The level of complexity for individual characteristics differs across applications. Complexity is based on the following factors – automation used in the organization, entity's reliance on system generated reports, customization in IT applications, business model of the entity, any significant changes done during the year and implementation of emerging technologies.

   After considering the above factors for each application the over complexity is assessed of the IT environment.



4. IDENTIFYING THE RISKS ARISING FROM USAGE OF IT

4.1 How to Identify the IT Risks?

In identifying the risks arising from the use of IT, the auditor may consider the nature of the identified IT application.

Applicable risks arising from the use of IT may also be identified related to cybersecurity.

It is more likely that there will be more risks arising from the use of IT when the volume or complexity of automated application controls is higher, and management is placing greater reliance on those controls for effective processing of transactions or the effective maintenance of the integrity of underlying information.

4.2 Risks Arising from Use of IT

- **Unauthorized access** to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel **gaining access privileges** beyond those necessary to perform their assigned duties thereby breaking down segregation of duties. Unauthorized changes to data in master files.
- **Unauthorized changes** to IT applications or other aspects of the IT environment.

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- **Failure to** make necessary **update** IT applications or other aspects of the IT environment.
- **Inappropriate manual intervention**.
- **Data loss or data corruption** is a major risk which arises from the use of IT. If appropriate cybersecurity controls and protocols not followed it may lead to loss of sensitive data, hackers might encrypt your system or illegally break into your system. Risk of fraud can arise if users alter the information or there is a case of physical security breach or theft of sensitive information.
- There is a **risk of system downtime** which is caused by hardware failures, faulty configurations, cyberattacks or power outage. It means the IT systems will not be operational or will be unavailable/offline which may hamper the business.
- Since companies uses more than one IT systems to support their business **system integration (means integrating one or more systems) and system compatibility** comes in place. However, system integration and compatibility have some risks. In case of system failure in one system may also lead to widespread failure in integrated systems. Or if the integration between two systems is not appropriate the end result would be incorrect. System compatibility means sharing compatible hardware, software and operating system while performing the integration. Compatibility risks arise if different versions of the same software are used, if the patches are not upgraded which may lead to bugs.
- With advancement in usage of IT the risk of regulatory compliances increases. Any change in the law, order, guidelines or agreements will impact the business, its related costs, investments etc. An FMCG sector will be subject to different regulatory requirements than a financial company, however both businesses will need to manage their respective compliance risks.

Performance Issues arises with the way requests are processed in the IT systems. Heavy data load, network usage impacts the application performance and its responsiveness. To overcome the performance issues of IT systems, resources or hardware can be added to an existing node, which is known as scaling. However, scaling can be expensive therefore an informed decision should be made in case of adding a hardware or changing the architecture.

4.3 Know How to Identify the IT Dependencies Impacting the Audit

4.3.1 Why is it important to identify IT dependencies?

Identifying and documenting the entity's IT dependencies in a consistent, clear manner helps to identify the entity's reliance upon IT, understand how IT is integrated into the entity's business model,

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identify potential risks arising from the use of IT, identify related IT General Controls and enables us to develop an effective and efficient audit approach.

4.3.2 How IT dependencies arise?

IT Dependencies are created when IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in financial statements.

There are five types of IT dependencies as described below:

Type	Description
Automated Controls	Automated controls are designed into the IT environment to enforce business rules. For example, Purchase order approval via workflow or format checks (e.g., only a particular date format is accepted), existence checks (e.g., Duplicate customer number cannot exist), and/or reasonableness checks (e.g., maximum payment amount) when a transaction is entered.
Reports	System generated reports are information generated by IT systems. These reports are often used in an entity's execution of a manual control, including business performance reviews, or may be the source of entity information used by us when selecting items for testing, performing substantive tests of details or performing a substantive analytical procedure. E.g. (Vendor master report, customer ageing report)
Calculations	Calculations are accounting procedures that are performed by an IT system instead of a person. For example, the system will apply the 'straight-line' depreciation formula to calculate depreciation of an asset (i.e., cost of the asset, less the residual value of the asset at the end of its useful life divided by the useful life of the asset) or the system will calculate the value of the amount invoiced to a customer by multiplying the item price times the quantity shipped.
Security	Security including segregation of duties is enabled by the IT environment to restrict access to information and to determine the separation of roles and responsibilities that could allow an employee to perpetrate and conceal errors or fraud, or to process errors that go undetected.
Interfaces	Interfaces are programmed logic that transfer data from one IT system to another. For example, an interface may be programmed to transfer data from a payroll sub-ledger to the general ledger.

4.3.3 Understanding and responding to risks arising from IT dependencies

When auditors identify IT dependencies that are relevant to the entity's flow of transactions and processing of financial information, they need to understand how management responds to the associated risks that may arise from them.

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Management may implement information technology general controls (ITGCs) to address risks related to IT dependencies.

The illustration below is an overview of the Control Objectives and controls for each area of General IT Controls:



IT dependencies may also affect the design of the entity's controls and how they are implemented.

Therefore, auditors consider IT dependencies relevant to audit and evaluate the related risks. The auditor should scope in ITGCs to tests when there are IT dependencies identified in the system. If the controls around the IT environment are not implemented or operating effectively it will result in not relying on ITGCs which means the IT dependencies cannot be relied upon.

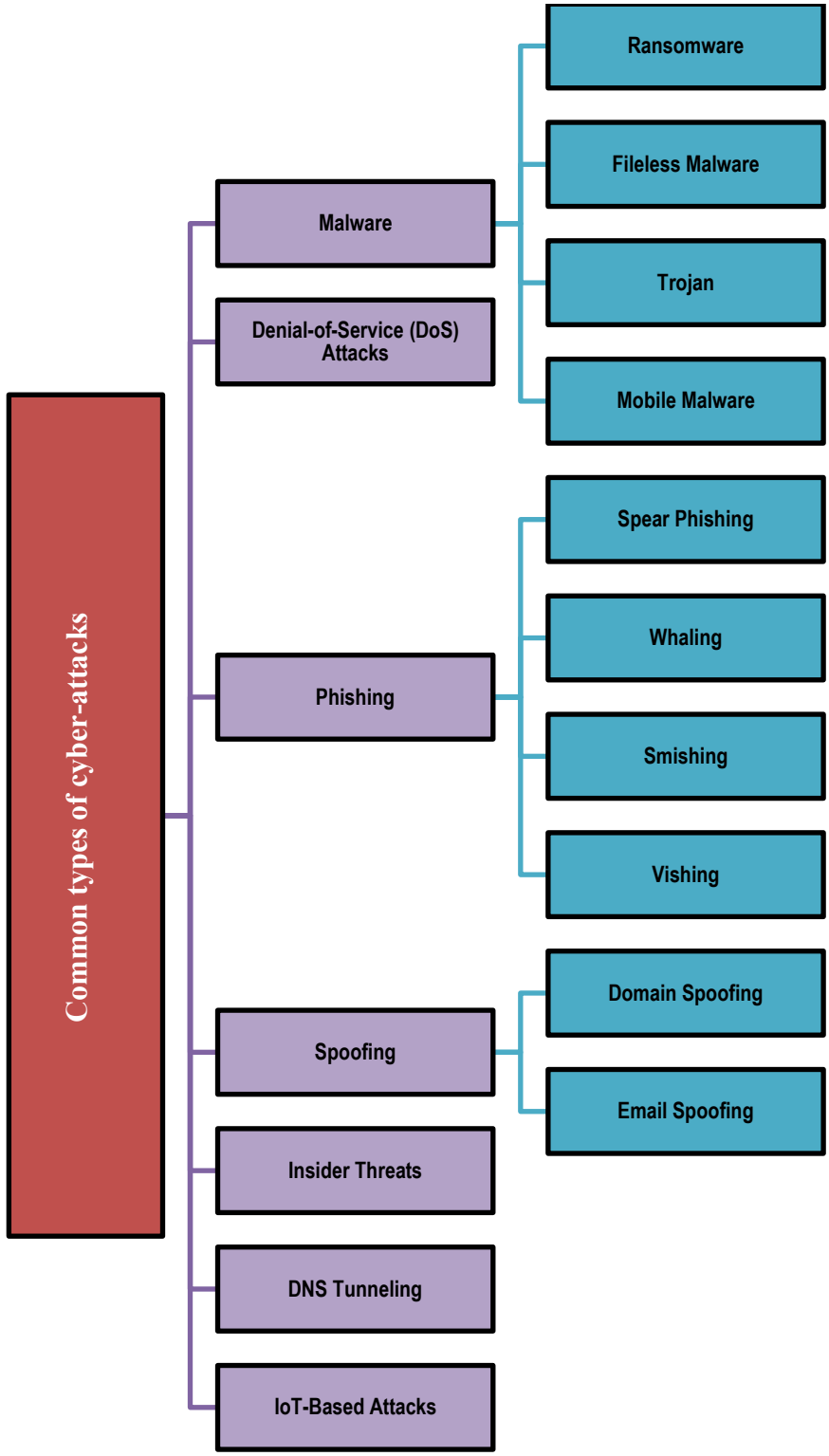
5. ASSESSING CYBER RISKS (INCLUDING REMOTE AUDIT)

5.1 What is Cyber Risk

A cyber-attack is an attempt to gain unauthorized access to a computing system or network with the intent to cause damage, steal, expose, alter, disable, or destroy data.

Regulators across the globe have placed the topic of cyber risk management under increasing scrutiny, requiring financial institutions to assess the maturity of their cybersecurity program, manage cyber risks, and enhance resiliency against cyber-attacks. Most common types of cyber-attacks are:

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- **Malware** : Malware or malicious software is any program or code that is created with the intent to do harm to a computer, network or server. Malware is the most common type of cyberattack, its subsets are ransomware, fileless Malware trojans, viruses etc.

Type	Description
Ransomware	In a ransomware attack, an adversary encrypts a victim's data and offers to provide a decryption key in exchange for a payment. Ransomware attacks are usually launched through malicious links delivered via phishing emails, but unpatched vulnerabilities and policy misconfigurations are used as well.
Fileless Malware	Fileless malware is a type of malicious activity that uses native, legitimate tools built into a system to execute a cyber-attack. Unlike traditional malware, fileless malware does not require an attacker to install any code on a target's system, making it hard to detect.
Trojan	A trojan is malware that appears to be legitimate software disguised as native operating system programs or harmless files like free downloads. Trojans are installed through social engineering techniques such as phishing or bait websites.
Mobile Malware	Mobile malware is any type of malware designed to target mobile devices. Mobile malware is delivered through malicious downloads, operating system vulnerabilities, phishing, smishing, and the use of unsecured Wi-Fi.

- **Denial-of-Service (DoS) Attacks** : A Denial-of-Service (DoS) attack is a malicious, targeted attack that floods a network with false requests in order to disrupt business operations. In a DoS attack, users are unable to perform routine and necessary tasks, such as accessing email, websites, online accounts or other resources that are operated by a compromised computer or network. While most DoS attacks do not result in lost data and are typically resolved without paying a ransom, they cost the organization time, money and other resources in order to restore critical business operations.

- **Phishing**: Phishing is a type of cyberattack that uses email, SMS, phone, social media, and social engineering techniques to entice a victim to share sensitive information — such as passwords or account numbers — or to download a malicious file that will install viruses on their computer or phone.

Type	Description
Spear Phishing	Spear-phishing is a type of phishing attack that targets specific individuals or organizations typically through malicious emails. The goal of spear phishing is to steal sensitive information such as login credentials or infect the targets' device with malware.

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Whaling	A whaling attack is a type of social engineering attack specifically targeting senior or C-level executive employees with the purpose of stealing money or information or gaining access to the person's computer in order to execute further cyberattacks.
Smishing	Smishing is a type of fraudulent practice of sending text messages purporting to be from reputable companies in order to induce individuals to reveal personal information, such as passwords or credit card numbers.
Vishing	Vishing, a voice phishing attack, is the fraudulent use of phone calls and voice messages pretending to be from a reputable organization to convince individuals to reveal private information such as bank details and passwords.



Mr. Rajan, the CEO of a mid-sized company, has received an email requesting him to urgently update his account details due to a supposed security breach. The said email, appears to be received from the Company's bank accounts, looks official due to use of bank's logo and branding. Such email also includes a link to a website that resembles the bank's login page. Concerned about the security of the company's finances, Mr. Rajan clicks on the link and enters his login credentials. Later, the company's IT department detects unauthorized access to the company's financial accounts and identifies that the CEO's credentials were compromised. The type of cyberattack that Mr. Rajan fell victim to is Spear Fishing.

- **Spoofing**: Spoofing is a technique through which a cybercriminal disguises themselves as a known or trusted source. In so doing, the adversary is able to engage with the target and access their systems or devices with the ultimate goal of stealing information, extorting money or installing malware or other harmful software on the device.

Type	Description
Domain Spoofing	Domain spoofing is a form of phishing where an attacker impersonates a known business or person with fake website or email domain to fool people into the trusting them. Typically, the domain appears to be legitimate at first glance, but a closer look will reveal subtle differences.
Email Spoofing	Email spoofing is a type of cyberattack that targets the businesses by using emails with forged sender addresses. Because the recipient trusts the alleged sender, they are more likely to open the email and interact with its contents, such as a malicious link or attachment.

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- **Identity-Based Attacks** : When a valid user's credentials have been compromised and an adversary is pretend to be that user. For e.g., people often use the same user ID and password across multiple accounts. Therefore, possessing the credentials for one account may be able to grant access to other, unrelated account.
- **Insider Threats** : When current or former employees that pose danger to an organization because they have direct access to the company network, sensitive data, and intellectual property (IP), as well as knowledge of business processes, company policies or other information that would help carry out such an attack.
- **DNS Tunneling :** DNS Tunneling is a type of cyberattack that leverages domain name system (DNS) queries and responses to bypass traditional security measures and transmit data and code within the network. This tunnel gives the hacker a route to unleash malware and/or to extract data, IP or other sensitive information by encoding it bit by bit in a series of DNS responses.
- **IoT-Based Attacks:** An IoT attack is any cyberattack that targets an Internet of Things (IoT) device or network. Once compromised, the hacker can assume control of the device, steal data, or join a group of infected devices

5.2 Stages of Cyber Risks

There are 3 Stage of cyber risk



Stage 1 - Assessing the cyber risk: No organization is completely immune to a cyber risk. Different clients will have different levels of risks, even with the same industry. Every organization should consider at least the common threats-

- Ransomware disabling their organization (including their plants and manufacturing facilities)
- Common criminals using email phishing and hacks for fraud and theft.
- Insiders committing malicious activities or accidental activities resulting in unintended discourse of information theft and frauds.

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Stage 2 - Impact of cyber risk: Cyber-attack can impact one, two or more types of risks. The impact of the attack would vary from organization to organization and most importantly from attack to attack. Some of the indicative areas can be –

- Regulatory costs.
- Business interruptions causing an operational challenge for an organization.
- Data loss, reputational loss and litigation.
- Ransomware - more common these days where entire systems are encrypted.
- Intellectual property theft which may not only take the competitive advantage, but we may also result in any impairment/impediment charge because of the loss of IP.
- Incident response cost which could be for investigations & remediations.
- Breach of Privacy, if personal data of a consumer is hacked it could have a significant impact on the organization.
- Fines and penalties.

Stage 3 - Managing cyber risk: A strategic approach to cyber risk management can help an organization to:

- Gain a holistic understanding of the cyber risks, threats facing their organization and other financial institutions.
- Assess existing IT and cybersecurity program and capabilities against the relevant regulatory requirements.
- Align cybersecurity and IT transformation initiatives with strategic objectives and critical risks.
- Understand accepted risks & documented compensating controls.

5.3 Cyber Security Framework

Cybersecurity framework includes how management is identifying the risk, protecting and safeguarding its assets (including electronic assets) from the risk. Management preparedness to detect the attacks, anomalies and responsiveness to the adverse event.

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5.3.1 Identify the risk

Auditor has to determine whether the entity's risk assessment process considers cybersecurity risks.

Entity should conduct a **periodic risk assessment & develop a management strategy** which identifies cybersecurity risks around IT system failure affecting the entity's primary business or potential loss of data or inability to access data as required, Risk of unauthorized access to the IT network.

The entity should maintain and periodically review an inventory of their information assets- i.e**., Asset Management** (e.g., intellectual property, patents, copyrighted material, trade secrets and other intangibles).

The entity should classify and prioritize protection of their information assets based on sensitivity and business value and periodically review the systems connected to the network on which digital assets reside.

From the **governance** perspective management should review how cybersecurity risks affect internal controls over financial reporting. In case of adverse attack how management is going to assess the impact on the recoverability of financial data and impact on revenue recognition.

Management needs to identify if any established a risk-based cybersecurity program can be leveraged e.g. (NIST, ISO etc.)

To determine overall responsibility for cybersecurity in the **business environment** entity should establish roles and responsibilities over cybersecurity (CISO, CIO). Further the risk assessment should be discussed with those charged with governance (e.g., the Audit Committee or Board of Directors).

5.3.2 Protect the risk

Obtained an understanding of the entity's processes for safeguarding of assets subject to cybersecurity. Entity monitors whether there has been **unauthorized access** to electronic assets and any related impact on financial reporting.

Formal **training** should be conducted to make the teams aware of the risk associated with cyber-attacks. Entity should implement effective controls for **data security**. Entity should have a process & procedures in place for identifying material digital/electronic assets on the balance sheet subject to cybersecurity risk (e.g., intellectual property, patents, copyrighted material, trade secrets) and prioritizing their protection based on criticality.

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5.3.3 Detect The risk

Entity should have controls and procedures that enable it to identify cybersecurity risks and incidents and to assess and analyse their impact on the entity's business, evaluate the significance associated with such risks and incidents, and consider timely disclosures.

Review entity's processes to monitor and detect security breaches or incidents. If management has implemented anti-virus in the system to secure it from anomalies or if firewall logs are being continuously monitored to detect any repetitive attacks. A monitoring process should be established to review how many such events have been denied by the firewall. The monitoring process should also include if any upgrades or updates are required to safeguard the systems from vulnerabilities.

5.3.4 Respond to the risk

In case of material cybersecurity or data breach has been identified management should capture the details of nature of incident and how the incident or data breach was identified. Entity should have a response planning in place to capture the details of nature of incident and the same needs to be communicated with those who are ultimately responsible for this framework and with those charge with governance.

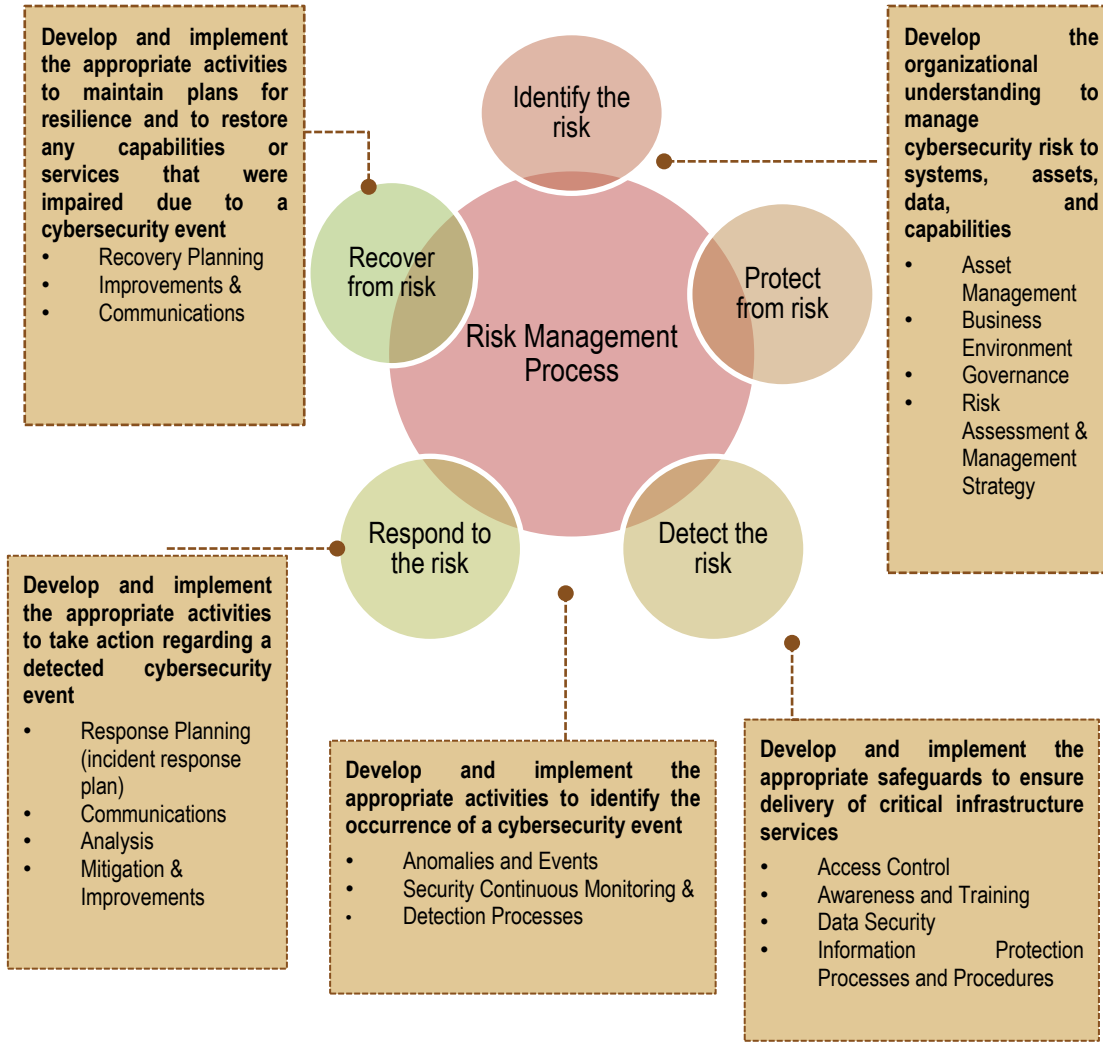
The security incident response plan helps in analysing the impact and severity of the attack and helps the organisation in taking the appropriate actions. Management should assess Litigation costs, Regulatory investigation costs and Remediation costs as a part of mitigation process and improvement management should assess the future action plans that needs to be taken to safeguard the organisation from such attacks.

5.3.5 Recover from risk

Entity should undertake appropriate actions to recover from the attack and make sure the business is up and running.

Once the impact evaluated and communicated with the regulators the recovery plan needs to be implemented to overcome the impact. Necessary improvements – like patch upgrades, better controls, improved technology in terms of firewall, anti-virus, tools etc needs to be implemented to safeguard the entity.

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TEST YOUR UNDERSTANDING 1

Sukanya, a CA final student, is of the view that cyber risks are issues of IT and result only in information loss to an entity. She also feels that many cyber-attacks are not directly targeted at financial systems and do not pose risk of material misstatements to financial statements of an entity. Is her view proper?

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Case study

What has happened:

The CEO of a hotel realized their business had become the victim of wire fraud when the accounts payable executive began to receive insufficient fund notifications for regularly recurring bills.

A review of the accounting records exposed a serious problem. Upon investigating it was noted that the CEO had clicked on a link in an email that he thought was from the trusted source. However, it wasn't and when he clicked the link and entered his credentials, the cyber criminals captured the CEO's login information, giving them full access to intimate business and personal details.

Type of Attack: Social engineering, phishing attack.

A phishing attack is a form of social engineering by which cyber criminals attempt to trick individuals by creating and sending fake emails that appear to be from an authentic source, such as a business or colleague. The email might ask you to confirm personal account information such as a password or prompt you to open a malicious attachment that infects your computer with malware.

Result: The hotel's cash reserves were depleted. The fraudulent transfers amounted to more than ₹1 million. The hotel also contacted a cybersecurity firm to help them mitigate the risk of a repeat attack.

Impact: The business lost ₹1 million, and the funds were not recovered. Further there was loss of business reputation too.

Lessons Learned:

- Train the staff about the dangers of clicking on unsolicited email links and attachments, and the need to stay alert for warning signs of fraudulent emails. Engage in regular email security training.
- Implement stringent wire transfer protocols and include a secondary form of validation (Multi Factor Authentication)
- Have a cyber incident response plan ready to implement.

5.4 Control considerations for Cyber Risks

Apart from having the cyber security policies, procedures, framework and regular assessment in place, management should have strong and updated internal controls to ensure they are covered from cyber risks

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1) Controls around vendor setup and modifications:

Certain cyber schemes exist in which changes to bank account or other critical vendor information are requested through email phishing scams by individuals purporting to be authorized vendor personnel.

Entities have inappropriately dispersed funds to these individuals and therefore inappropriately reduced the liability owed to the actual vendor, resulting in an impact to the financial statements (i.e., loss of cash and related expense)

- Who is responsible for making changes to vendor master data? Is the process centralized or decentralized?
- Are other communication channels, such as email, used to request changes to vendor master data? (If yes, consider if multi-factor authentication is enabled for email).
- What systems and technologies are used to initiate, authorize and process requests related to changes to vendor master data?
- Are authentication protocols defined to verify modifications to vendor master data (e.g., call back procedures, multi-factor authentication)?

2) Controls around electronic transfer of funds:

Wire transfers or electronic funds transfers, similar to vendor changes noted above, cyber schemes pertaining to fraudulent requests for wire transfers are made relating to business transactions and vendor payments, as well as fraudulent requests appearing to come from financial institutions requesting disbursement from customer asset accounts.

- Are personnel responsible for wire transfers educated on the relevant threats and information related to common phishing scams associated with fraudulent requests for wire transfers?
- Are authentication protocols defined to verify wire transfer requests (e.g., call back procedures, dual-authentication procedures)?
- What systems and technologies are used to facilitate the request/initiation, authorization and release of 0 wire transfers?

3) Controls around patch management:

Cyber and ransomware attacks exploit known security vulnerabilities resulting in the manipulation or the destruction of data. Exploitations of known security vulnerabilities are often caused by unapplied patches or upgrades.

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- Does the entity have a patch management program?
- Does the entity run periodic vulnerability scans to identify missing/unapplied patches?
- How is the entity notified of patches by external vendors (e.g., Microsoft for Windows patches)?

5.5 Remote Audit

Remote audit or virtual audit is when the auditor uses the online or electronic means to conduct the audit. It could be partially or completely virtual, auditor engages using technology to obtain the audit evidence or to perform documentation review with the participation of the auditee.

Audit planning and scoping is crucial in every audit. This includes a discussion of the scope and schedule, and the ways to conduct audit. The COVID-19 pandemic has changed the entire business landscape and processes have been adjusted to this new situation, where remote audit is appreciated by clients as well.

Considerations for remote audit

Auditors must develop tailored strategies to ensure the remote audit meets the requirements and deliver results equivalent to traditional onsite audits.

Feasibility and Planning

- Planning should involve agreeing on audit timelines, meeting platform (Zoom calls/ Microsoft Teams/Google Meet) to be used for audit sessions, data exchange mechanisms, any access authorization requests. Ensure feasibility is determining what technology may be used, if auditors and auditees have competencies and that resources are available.
- The execution phases of a remote audit involve video/tele conferencing with auditees. The documentation for audit evidence should be transferred through a document sharing platform.

Confidentiality, Security and Data Protection

- To ensure data security and confidentiality, access to document sharing platform should be sufficiently restricted and secured by encrypting the data that is sent across the network. The information, once reviewed and documented by auditor, is removed from the platform, and stored according to applicable archiving standards and data protection requirements.

  Auditors should take into consideration legislation and regulations, which may require additional agreements from both sides (e.g., there will be no recording of sound and images, or authorizations to using people's images). Auditors should not take screenshots of auditees

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as audit evidence. Any screenshots of documents or records or other kind of evidence should be previously authorized by the audited organization. In case of accessing the auditee's IT system auditor should use VPN (Virtual private network). VPN is a service which creates safe and encrypted online connections. It prevents unauthorized users to enter into network and allows the users to perform work remotely.

Risk assessment

- The communication from auditor as well as auditees need to clear and consistent, and this becomes crucial during remote audit. The risks for achieving the audit objectives are identified, assessed and managed. The assessment if remote audit would be sufficient to achieve the audit objectives should be done and documented for each audit involving all members of the audit team and the audited organization representative.

Advantages and Disadvantages of Remote Audit

ADVANTAGES	DISADVANTAGES
Cost and time effective: No travel time and travel costs involved.	Due to network issues, interviews and meetings can be interrupted.
Comfort and flexibility to the audit team as they would be working from home environment,	Limited or no ability to visualize facility culture of the organization, and the body language of the auditees. Time zone issues could also affect the efficiency of remote audit session
Time required to gather evidence can spread over several weeks, instead of concentrated into a small period that takes personnel from their daily activities.	The opportunity to present doctored documents and to omit relevant information is increased. This may call for additional planning, some additional/different audit procedures, Security and confidentiality violation.
Auditor can get first-hand evidence directly from the IT system as direct access may be provided.	Remote access to sensitive IT systems may not be allowed. Security aspects related to remote access and privacy needs to be assessed
Widens the selection of auditors from global network of experts.	Cultural challenges for the auditor. Lack of knowledge for local laws and regulations could impact audit. Audit procedures like physical verification of assets and stock taking cannot be performed.

Remote auditing plays a vital part, and provides assurance when unprecedented circumstances, like COVID. It provides an opportunity for organisations and auditors to leverage communication technology tools. In addition, management perception about remote audits is changing as it provides

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flexibility in terms of time ensuring that day-to-day business activities are not impacted, along with the reductions in cost.

Auditor should also consider while performing audit using remote means, if access to system and network is provided post appropriate approvals both to employees who are working remotely and to auditors who are auditing remotely and if data is transferred through encrypted means to maintain data privacy. Management should maintain and review the list of people who are working remotely and make sure they access the system and network through VPN (Virtual Private Network) only and such access should be approved. Further once the employee leaves the organisation or audit is completed such VPN access should be terminated timely. Auditors can test such controls while performing remote audit.

6. EMERGING TECHNOLOGIES IN AUDIT

Emerging technologies are altering the financial reporting environment substantially, and this change is accelerating. Some examples of emerging technologies are – Data analytics (CAATs (ACL, Alteryx, Power BI, CaseWare), artificial intelligence (AI), robotic process automation, and blockchain. These are changing the way business gets done, and auditors are leading by transforming their own processes.

As the use of emerging technologies in the financial reporting process increases, it becomes important for auditor and the client to upskill on the emerging technologies. Some important considerations for auditors are to assess the impact of emerging technologies on business and evaluate whether management is properly assessing the impact of emerging technologies on internal control over financial reporting.

Data Analytic Techniques

Generating and preparing meaningful information from raw system data using processes, tools, and techniques is known as Data Analytics. Audit analytics or audit data analytics involves analyzing large sets of data to find actionable insights, trends, draw conclusions and for informed decision making. The use of audit analytics enables greater efficiencies and more accurate findings from the review process.

As a result, businesses will be able to create strategies based on verifiable data and professional assumptions and auditors can improve the audit quality. It allows auditors to more effectively audit the large amounts of data held and processed in IT systems in larger clients.

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Audit analytics helps:

- To discover and analyse patterns
- Identifying anomalies
- Extract other useful information in data

The data analytics methods used in an audit are known as Computer Assisted Auditing Techniques or CAATs. It involves use of multiple data analytical tool or visualization tools that can help the auditor to deep dive into the problem statement and hence increase the audit quality. This also minimizes the scope of missing out on key attributes that might be of a higher risk to the organization and its respective business.

Auditor performing audit analytics can make use of various applications and tools that help them to analyse large data sets and obtain insights that help them to make the quality of the audit better. Some of the popular tools used across the industry as part of CAATs are listed below:

1. **ACL** - Audit Command Language (ACL) Analytics is a data extraction and analysis software used for fraud detection and prevention, and risk management. It samples large data sets to find irregularities or patterns in transactions that could indicate control weaknesses or fraud.



ACL (Audit Command Language) is used to analyse and check complete data sets to perform Trial Balance reconciliations during the Audits. In such case scenarios, the entity provided the General Ledger dump and system Trial Balance. Using ACL, the completeness of the data can be ensured as the data set exceeded beyond the capacity of the excel and basic functions like record count, sum, pivoting can be performed within ACL where excel could not perform such actions.

2. **Alteryx** - Alteryx is used to consolidate financial or operational data to assess controls. A fully transparent audit trail of every action is performed in Alteryx in form of a workflow which makes it easier for the user to learn as no prior knowledge of coding or scripting is required. Alteryx can also be leveraged to automate analytics and perform Machine Learning to search for patterns indicative of fraud or irregularities speed up your processes like accounting close, tax filings, regulatory reporting, forecast creation etc. It can also be used to automate set procedures that are performed periodically like reconciliations, consolidations, marketing workflows, system integrations, continuous audits etc.



Alteryx used for logistics organization to recompute the revenue entries recorded by the system to match with the financials that showcased the expected revenue turnover. Due to Alteryx's processing speed and ease to

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implement functions, auditors could perform re-computation for all the transactions entry and noted that the revenue was being understated as the expected revenue was more than the actual calculated. This was due the fact that the addendum between the logistic company and the client was not revised in the system and old versions of rates were used to compute the revenue. Alteryx helped in analysing and recomputing the huge data set and to focus on actual risk.

3. **Power BI** – Power Bi is a business intelligence (BI) platform that provides nontechnical business users with tools for aggregating, analyzing, visualizing and sharing data. From audit perspective, such visualization tools can be used to find the outliers in the population, it can also be used for reporting purpose (audit reports) in an interactive dashboard to the higher management.



Power BI dashboard used for checking the outliers of the apparel company. Auditors were required to analyse the trends of the sales during the year. By the use of Power BI, the sales data provided by the client was further converted into dashboard to analyse the trends and patterns as per the market standards.

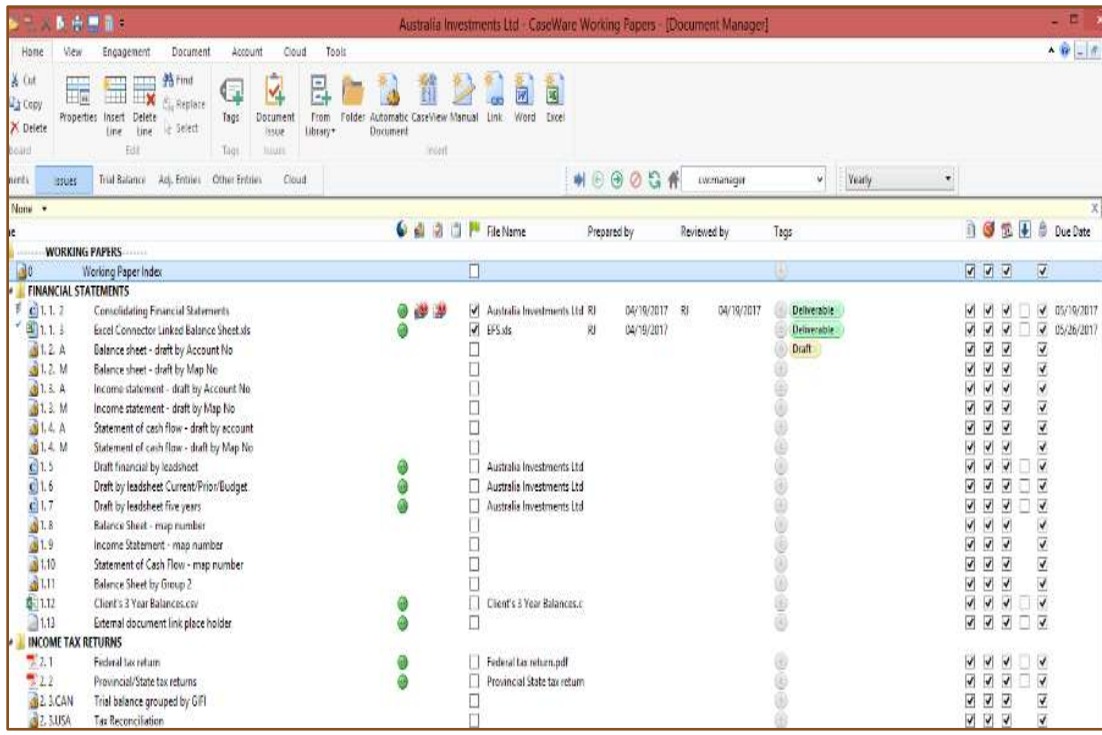
In analysis performed on untimely sales, it was noted that sales transactions were performed during non-business hours. Illustrative charts below which were utilized as part of the analysis by the auditors.



4. **CaseWare** – CaseWare is a data analysis software & provide tools that helps in conducting audit and assurance engagements quickly, accurately and consistently. It shares analytical insights which help in taking better informed decisions. It helps in streamlining processes and eliminating the routine tasks. Used by accounting firms, governments and corporations worldwide, this trusted platform integrates everything you need to conduct assurance and reporting engagements.

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CaseWare provides the solutions to build accounting software which turns any document, including financial statements into cost effective client ready report. It automatically links to client data and securely communicate with the client in real time. Regardless of location, all authorized users have access to the same documents. Consistency of data is ensured. Refer screenshot below to illustrate audit, review and compilation process maintained on-screen.



TEST YOUR UNDERSTANDING 2

CA Y is planning to use CAATs extensively in audit of a company-be it for compliance tests or substantive tests. Can you list out examples of few situations (in brief) of tests performed by him using CAATs?

7. AUTOMATED TOOLS IN AUDIT

Enterprises are adopting emerging technologies at a rapid pace to create synergies and harness the latest technologies.

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Robotic process automation (RPA), blockchain, machine learning, Internet of Things (IOT) and artificial intelligence (AI) are some prime examples of automation.

Automation and use of technology often requiring auditors to understand and perform procedures on a larger group of systems that produce information relevant to the production of financial statements.

Based on managements and auditors' independent risk assessment procedures, the audit's scope may need to include peripheral systems, as well as testing general IT and application controls relative to those systems due to the increased use of technology that is relevant to financial reporting.

7.1 Internet of Things

IoT is the concept of connecting any device (cell phones, coffee makers, washing machines, and so on) to the internet. Key components of IoT are data collection, analytics, connectivity, and people and process. IoT not only changes the business model, but also affects the strategic objectives of the organization. The risk profile of the entity changes with exposure to new laws and regulations.



Connected Cars, connected manufacturing equipment's, smart home security, (The options for home security from doorbell cameras or outdoor cameras - users can view video feeds when they are away from home) or Data from machines can be used to predict whether equipment will break down, giving manufacturers advance warning to prevent long stretches of downtime. Or a refrigerator placing an order with a grocery store whenever the supply of eggs falls below a certain number. Or smart oven works by scanning QR or bar codes and connecting to Wi-Fi, which it then uses to determine the best temperature and time to cook the food to avoid undercooking or burning. Researchers uses IoT devices to gather data about customer preferences and behavior, though that can have serious implications for privacy and security.

Audit Implications

A shift to connected devices and systems may result in auditors not being able to rely only on manual controls. Instead, auditors may need to scope new systems into their audit. Audit firms may need to train and upskill auditors to evaluate the design and operating effectiveness of automated controls.

Consumer-facing tools that connect to business environments in new ways can impact the flow of transactions and introduce new risks for management and auditors to consider. Consider payment processing tools that allow users to pay via credit card at a retail location through a mobile device. This could create a new path for incoming payments that may rely, in part, on a new service provider

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supplying and routing information correctly. Auditors would need to consider the volume of those transactions and the processes and controls related to it.

Common risks of IoT:

The key risks associated with IoT, including, device hijacking, data siphoning, denial of service attacks, data breaches and device theft.

7.2 AI (Artificial intelligence)

Artificial intelligence (AI) refers to a system or a machine that can think and learn. AI systems utilize data analysis and algorithms to make decisions based on predictive methods. Complex algorithms are developed to propose decisions based on a pattern or behavior learned over time.



Self-driving cars, manufacturing robots, smart assistants, marketing chatbots, virtual travel booking agent. The self-deploying robots can determine how much vacuuming there is to do based on a room's size, uses AI to scan room size, identify obstacles and remember the most efficient routes for cleaning.

Siri to help find your Air Pods or told Amazon Alexa to turn off the lights, quick commands to open a phone camera or start a particular playlist, AI to predict when to book the lowest prices for flights, hotels, car and vacation home rentals. Using historical flight and hotel data, AI will also recommend to the user whether the booking has reached its lowest price point or if the user should hold out a bit longer for the price to drop.

Auditor Implications

Given the invisible nature of algorithms, audits must focus on the logical flow of processes. A review of AI should ascertain whether unintended bias has been added to the algorithms. Auditors should assess the effectiveness of algorithms and whether their output is appropriately reviewed and approved. Because AI is built on software modules, auditors must also consider cybersecurity and search for possible bugs and vulnerabilities that can be exploited to impact AI functionality. Auditors should confirm their understanding of how the use of AI affects the entity's flows of transactions, including the generation of reports or analytics used by management. Auditors also should consider whether the AI is making decisions—or being utilized by management as part of the decision-making process.

If management shifts its focus on oversight by relying on AI, auditors should understand what shift occurred, how new risks might be addressed, and whether existing risks may not be getting the same level of attention. Understanding these changes could drive changes in the audit approach.

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Common risks for AI

AI comes with list of risks. Security is one of the key risks – the more data the system uses, from more sources, the more entry points and connections are formed and the greater the potential risks. Inappropriate configuration - AI may also be used to diagnose medical conditions. If it is badly configured or malfunctions, it could harm people before the problem is spotted. Data privacy - The data used and shared should have the necessary explicit consent from data providers.

7.3 Blockchain

Blockchain is based on a decentralized and distributed ledger that is secured through encryption. Each transaction is validated by the blockchain participants, creating a block of information that is replicated and distributed to all participants. All blocks are sequenced so that any modification or deletion of a block disqualifies the information.

Despite resistance, the benefits associated with blockchain technology are being recognized across a variety of other industries.



Bitcoin, cryptocurrency transfer application - Blockchain in money transfer, blockchain smart contracts.

Audit Implications

Auditors should consider the appropriate governance and security around the transactions. Although blockchain's core security premise rests on cryptography, there are risk factors associated with it. As blockchain interacts with legacy systems and business partners, concerns related to insecure application programming interfaces (APIs), data confidentiality and privacy cannot be ignored.

Weak blockchain application development protocols are something auditors cannot overlook. Similarly, data privacy laws and regulations may be an area of concern as data are communicated across geographic boundaries. Auditors must be able to determine whether the data put on blockchain will expose the enterprise for noncompliance with applicable laws and regulations.

Common risks for blockchain technology

The strengths of blockchain can also be its weaknesses. The inability to reverse transactions and to access data without the required keys make the system secure, but also mean that organisations need specific protocols and management processes to ensure that they are not locked out and have clear contingency plans. Operating through network nodes could also expose the organisation to cyber-attacks and data hacks, so security issues are important. Auditors should also ensure that the

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organisation has the necessary data management processes which complies with regulations. The regulatory landscape is still evolving for blockchain, so audit teams should check that compliance managers are following developments constantly and adapting processes accordingly.

7.3.1 NFT (Non-Fungible Token)

NFT means something is unique and cannot be replaced. Unlike physical money and cryptocurrencies are fungible (means they can be traded or exchanged for one another) NFTs are non-fungible tokens. NFTs contain the digital signature which make them unique. NFTs are digital assets, e.g., photos, videos, artwork, sports collectibles etc.

NFTs are tokens used to represent ownership of unique items. NFTs allow their creators to tokenize things like art, collectibles, or even real estate. They are secured by the blockchain and can only have one official owner at a time. No one can change the record of ownership or copy/paste a new NFT into existence.

Key Features of NFT -

- **Digital Asset** - NFT is a digital asset that represents Internet collectibles like art, music, and games with an authentic certificate created by blockchain technology that underlies Cryptocurrency.
- **Unique** - It cannot be forged or otherwise manipulated.
- **Exchange** - NFT exchanges take place with cryptocurrencies such as Bitcoin on specialist sites.

Challenges of NFT –

NFTs has its own challenges like ownership and copyright concerns, security risks, market is not that wide, online frauds etc. NFT audit considerations include comprehensive code review for verifying the safety of a token, valid contract, data privacy and potential cyber threat.

Case Study

XY Bank, headquartered in New York, offers a broad range of financial services including asset management, commercial banking, investment banking, and treasury and securities services.

The Five Indian banks in partnership with XY bank, provide a comprehensive range of banking services and products encompassing retail banking, corporate banking, international banking, and other financial services. All these banks have been significant contributors to the digitalization of banking services in India.

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Under the pilot programme, the Indian banks will open on-chain Nostro accounts with XY Bank branch in Gift City. The blockchain-based system is expected to facilitate instant, 24×7 settlement between the accounts held at the US bank. Essentially, it will create a private intra-correspondent banking network, redefining the traditional banking hours and enabling seamless money transfer.

Following are the illustrative steps for performing audit of above said block chain:

(a) Obtain a comprehensive understanding of the blockchain-based pilot program, including its objectives, scope, and key processes involved.

(b) Review the partnership agreements, contracts, and legal documentation governing the relationship between the Indian banks and XY Bank.

(c) Identify the specific blockchain technology used, its functionalities, and the underlying smart contracts.

(d) Assess Internal Controls:

Review policies and procedures related to the on-chain Nostro accounts, settlement processes, and money transfer mechanisms.

Assess the governance framework, risk management practices, and compliance procedures established by the Indian banks and XY Bank.

(e) Review Security Measures:

Assess encryption methods, cryptographic key management, and secure transmission protocols used for data protection.

Review measures taken to prevent unauthorized access, cyber threats, and potential vulnerabilities in the blockchain network.

(f) Test Transaction Validity and Accuracy:

Validate that transactions are recorded and settled accurately on the blockchain, ensuring adherence to relevant regulations and contractual obligations.

Perform reconciliations between on-chain Nostro accounts and the corresponding accounts held at XY Bank to confirm the accuracy of balances and transactions.

(g) Evaluate Compliance and Regulatory Requirements:

Review documentation and procedures related to customer due diligence, transaction monitoring, and reporting obligations.

Ensure that the pilot program adheres to industry-specific standards and best practices.

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(h) Assess Business Continuity and Disaster Recovery:

Evaluate the adequacy of backup and recovery procedures, redundancy measures, and failover mechanisms to ensure uninterrupted operations.

Test the effectiveness of these plans by conducting simulations or examining historical incidents and response procedures.

(i) Report Findings and Recommendations:

Provide recommendations for improving internal controls, security measures, compliance procedures, and overall efficiency and effectiveness of the pilot program.

Communicate the audit results to the relevant stakeholders, highlighting areas of concern and suggesting remedial actions.

7.4 Robotic Process Automation

RPA is the automation of the repetitive processes performed by users. It is a software technology that emulate humans' actions interacting with digital systems and software. Process efficiency, customer experience and control effectiveness contributed to RPA. Robotic Process Automation software bots can interact with any application or system the same way people do—except that RPA bots can operate around the clock, nonstop, much faster and with 100% reliability and precision.

Case Study

A large passenger carrier is having an AI bot for passenger ticket booking with following processes:

User Interaction: The bot interacts with passengers through various channels such as a website, mobile app, or messaging platforms. Passengers can initiate a conversation with the bot by providing their travel details, preferences, and other required information.

Natural Language Processing (NLP): The bot utilizes natural language processing techniques to understand and interpret the passenger's queries and requests. It can process text or voice inputs and extract relevant information to facilitate ticket booking.

Query Handling: The bot responds to passenger queries related to ticket availability, fares, train schedules, seat preferences, and other relevant information. It can provide real-time updates and answers to common passenger questions.

Booking Process: Upon receiving a booking request, the bot collects the necessary details from the passenger, including travel dates, destinations, class preferences, and passenger information.

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It validates the inputs, checks seat availability, and calculates fares based on the carrier's pricing structure.

Integration with Booking Systems: The bot interfaces with the carrier's booking systems to check seat availability, reserve seats, and process payment transactions. It securely communicates with the backend systems to initiate the booking process.

Payment Processing: The bot facilitates secure payment transactions, allowing passengers to provide payment details and complete the booking. It may integrate with various payment gateways or services to process credit card payments, net banking, or other payment methods.

Confirmation and Ticket Generation: Once the booking is successfully processed, the bot generates a booking confirmation along with a unique ticket number. It provides the passenger with the necessary information, including the ticket details, train information, and any other relevant instructions.

Ancillary Services: The bot may offer additional services such as seat upgrades, meal selection, travel insurance, or other ancillary offerings. It can provide information and assist passengers in availing these services during the booking process.

Post-Booking Support: The bot can assist passengers with post-booking support, including itinerary changes, cancellations, or ticket modifications. It handles these requests, checks the carrier's policies, and processes the necessary changes as per the passenger's requirements.

Integration with Customer Support: The bot may be integrated with customer support systems to escalate complex queries or issues to human agents when necessary. It can provide a seamless transition from automated assistance to human interaction, ensuring a high level of customer service.

Following are the illustrative steps to audit ticket booking bot system:

- Identify the objectives and goals of auditing the IRCTC ticket booking bot.
- Determine the scope of the audit, including the specific aspects of the bot's functionality and operations to be evaluated.
- Review relevant regulatory and compliance standards applicable to the ticket booking process, such as data protection and privacy regulations, payment card industry standards, and any specific industry guidelines.
- Identify and assess potential risks associated with the ticket booking bot, such as unauthorized access to customer data, system failures, or inaccurate booking information.

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- Develop a comprehensive set of audit procedures to assess the effectiveness, efficiency, and compliance of the ticket booking bot. This may include:
- Reviewing the system architecture, design, and documentation.
- Evaluating the security measures in place, including authentication, access controls, and encryption.
- Testing the bot's functionality by simulating booking scenarios and verifying the accuracy of the results.
- Assessing the performance of the bot, such as response times and scalability.
- Analyzing logs and audit trails to detect any unusual or suspicious activities.
- Examining the data handling processes, ensuring proper encryption, storage, and protection of customer data.
- Verifying compliance with relevant regulations, policies, and procedures.
- Conducting penetration testing or vulnerability assessments to identify potential weaknesses in the bot's security.
- Decide on the appropriate sampling methodology to evaluate the bot's performance and compliance. This may involve selecting a representative sample of booking transactions or data for analysis.
- Conduct the audit based on the defined procedures, following best practices and professional audit standards.
- Document your findings, including any issues or areas of improvement identified during the audit.
- Compile the audit findings into a comprehensive report, detailing the audit objectives, scope, procedures performed, and results.
- Provide recommendations for addressing any identified weaknesses, risks, or non-compliance issues.
- Present the report to relevant stakeholders, such as management, IT teams, and compliance officers.
- Track the implementation of recommended actions and ensure appropriate measures are taken to address any identified weaknesses.
- Periodically review and monitor the bot's performance, security, and compliance to ensure ongoing effectiveness.

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Audit Implications:

It is of utmost importance for auditors to understand RPA processes, which include data extraction, aggregation, sanitization and cleansing. Unless auditors understand these processes, they will not be in a position to initiate an audit.

A comprehensive assurance process might demand review of the source code. To perform substantive testing, auditors must have an understanding of the tools used to develop and maintain RPA. This will be helpful when auditors review logs, configuration controls, privileged access controls and the like. General IT controls are applicable as always.

Common Risks of RPA:

Operational and execution risks - Robots are deployed without proper operating model. Buying the wrong tool, making wrong assumptions, taking shortcuts, and jeopardizing security and compliance. Assigning proper responsibilities, training and clearly stating about changing roles also can help you reduce operational risk to a great extent.

Change management risks: Not following the change management implementation lifecycle, improper and incomplete testing (not covering all scenarios) leads to inaccurate results.

RPA Strategy Risk: Setting wrong expectations, improper KPIs, and unrealistic business goals creates an environment of uncertainty. Management should discuss, and analyse the complete working characteristics, potential, and limitations of RPA before drafting a robotic process automation.

RPA to check IND AS, IFCoFR and Standards on Auditing.

Incorporating Standards on Auditing, IFCoFR, IND AS (para-wise details of | Para reference | Accounting policy | Relevant data to be captured | Relevant calculation to be made | Presentation in financial statements | IFCoFR | Audit procedures as per Standards on Auditing |) in audit practices ensures accurate financial reporting, effective internal controls, and reliable audit procedures. Leveraging RPA in conjunction with these frameworks can significantly enhance audit efficiency, accuracy, and compliance. RPA developers and auditors should collaborate to align RPA workflows with relevant standards and guidelines, ultimately improving the effectiveness of audits and enhancing client assurance, a specimen of the same is given at the end of the Chapter as Annexure.

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8. CONTROL CONSIDERATIONS OR OBJECTIVES OF AUDITING DIGITALLY

Emerging technologies can bring great benefits, but they also come with a varied set of substantial risks.

The strength of the auditing profession is the assessment of risks and controls. As they address the challenge of assessing technology risk, auditors can and should focus on the following control considerations:

1. Auditors should gain a **holistic understanding of changes** in the industry and the information technology environment to effectively evaluate management's process for initiating, processing, and recording transactions and then design appropriate auditing procedures.

2. Auditors, as appropriate, should **consider risks resulting from** the implementation of **new technologies** and how those risks may differ from those that arise from more traditional, legacy systems.

3. Auditors should consider whether **digital upskilling or specialists** are necessary to determine the impact of new technologies and to assist in the risk assessment and understanding of the design, implementation, and operating effectiveness of controls. E.g., cybersecurity control experts, IT specialists in the team etc.

Some examples of technology risks where auditors should test the appropriate controls for relying on the digital systems

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both
- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions (specific risks might arise when multiple users access a common database)
- The possibility of information technology personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby leading to insufficient segregation of duties
- Unauthorized or erroneous changes to data in master files
- Unauthorized changes to systems or programs

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- Failure to make necessary or appropriate changes to systems or programs
- Inappropriate manual intervention
- Potential loss of data or inability to access data as required
- Risks introduced when using third-party service providers
- Cybersecurity risks

8.1 Key Steps for Auditors in a Changing Technology Environment

As auditors obtain an understanding of the impact of technology on a company's business, its systems of internal control, and its financial reporting, some important reminders include the following:

- Maintain sufficient professional skepticism when reviewing management's risk assessment for new systems.
- Understand the direct and indirect effects of new technology and determine how its use by the entity impacts the auditor's overall risk assessment.
- Understand how the technologies impact the flow of transactions, assess the completeness of the in-scope ICFR systems, and design a sufficient and appropriate audit response.
- Assess the appropriateness of management's processes to select, develop, operate, and maintain controls related to the organization's technology based on the extent the technology is used.

TEST YOUR UNDERSTANDING 3

A company is planning to use Robotics process automation (RPA) to streamline its hiring process. Earlier, the company used to hire from campuses of various management institutes leading to high recruitment costs, inefficient hire yield and resultant lack of diversity. How RPA can be used to automate the hiring process? List out tentative few such steps. What could be likely benefits of using RPA in hiring process?

9. NEXT GENERATION AUDIT

The Next Generation Audit is human-led, tech-powered and data-driven. It is based on combining emerging technologies to redefine how audits are performed.

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Next Generation Audit aims to the following:



We live in an era of fast technological progress, with new digital devices, applications, and tools being developed almost on a daily basis. 3D printing, augmented reality (AR) and virtual reality (VR), biotechnology, auditing through drones (also known as an 'Unmanned Aerial Vehicle' (UAV)and quantum technology are some of the most rapidly advancing areas, with many implications for society.



Drone Technology: Using drone technology in the remote locations for stock counts. Drones have great payload capacity for carrying sensors and cameras, thus they can photograph and physically examine the count of large quantities of fixed assets and inventory.

Drone captured audit information can be combined with various alternative sources of information such as QR code readers, handheld bar scanners, manual counts etc. to optimise quality of deliverables, consolidate audit information and enhance the execution speed while ensuring correctness and completeness of data.

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Augmented reality: The technology allows users to view the real-world environment with augmented (added) elements, generated by digital devices.

One famous example was Pokémon Go, a game for mobile devices in which players chase imaginary digital creatures (visible on their mobile phones) around physical locations.

Virtual reality: VR goes a step forward and replaces the real world entirely with a simulated environment, created through digitally generated images, sounds, and even touch and smell. Using special equipment, such as a custom headset, the user can explore a simulated world or simulate experiences such as flying or skydiving.

Examples of augmented and virtual reality? In architecture and engineering businesses, AR and VR allow architects to see their building plans come to life before being built. In the business sector, these technologies allow products to be previewed or customised, thus improving productivity and offering new marketing possibilities.

In the health sector, AR can provide surgeons with additional information when operating on a patient, such as heartbeat and blood pressure monitoring and virtual x-rays. Vision Pro is essentially an augmented-reality (AR) headset that "seamlessly" blends the real and digital worlds. The device can switch between augmented and full virtual reality (VR) using a dial.

Metaverse: The metaverse is the emerging 3-D digital space that uses virtual reality, augmented reality, and other advanced internet technology to allow people to have lifelike personal and business experiences online. It represents a convergence of digital technology to combine and extend the reach and use of Cryptocurrency, Artificial Intelligence (AI), Augmented Reality (AR) and Virtual Reality (VR)

The internet offers many experiences today, but tomorrow's Metaverse will feel more interconnected than ever before. We are heading towards mature landscape of virtual spaces with transferable identities and assets enabled by blockchains (NFTs) that are interoperable or interchangeable. It further includes highly automated systems, immersive interfaces, hyperconnected networks and digital reflections.

Some considerations for future –

- Beyond cryptocurrencies, coins, and exchanges, players in the Metaverse will need to consider how to build digital monetary systems and apply economic principles to things like digital land.
- Governance models will become ever more difficult to balance openness and user contribution with strategic direction and innovation.

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- Identity in the digital world has historically been different based on the platform utilized. The practical challenge of identity will also have to be considered in the Metaverse (e.g., KYC)
- Synchronicity is the ability for aspects of the Metaverse to be multiplayer, simultaneous, and real-time. This includes transactions and actions happening in the Metaverse and are dependent on the infrastructure of digital economies, networking and computing power required to operate a digital world.

Case scenarios to illustrate the potential application of the metaverse in the financial domain:

- **Virtual Banking and Transactions**: A forward-thinking financial institution, establishes a presence in the metaverse to offer virtual banking services. Users can create virtual bank accounts, access personalized financial dashboards, and perform transactions using virtual currencies. Customers can seamlessly transfer funds, make virtual purchases, and engage in virtual commerce, all within the immersive environment of the metaverse. XYZ Bank leverages the metaverse to provide a convenient and interactive banking experience, attracting tech-savvy customers who value digital innovation.
- **Digital Asset Management**: A digital asset management company, recognizes the growing popularity of virtual assets in the metaverse. They launch a virtual asset trading platform within the metaverse, allowing users to buy, sell, and trade NFTs and other digital assets. Investors can diversify their portfolios, participate in virtual auctions, and even showcase their virtual art collections in virtual galleries. Crypto Investments Ltd. leverages the metaverse's decentralized and secure infrastructure to facilitate transparent and efficient transactions of virtual assets.
- **Virtual Financial Education and Training**: A Financial Learning Academy aims to enhance financial literacy using the metaverse. They create a virtual classroom environment where participants can attend interactive financial education sessions. Students can engage in simulated investment activities, learn about budgeting and financial planning, and gain hands-on experience through virtual trading simulations. Financial Learning Academy leverages the immersive nature of the metaverse to provide an engaging and practical financial education platform, preparing individuals for real-world financial challenges.
- **Virtual Meetings and Conferences**: For a leading industry even an organisation hosts a virtual conference within the metaverse. Participants from around the world can access the conference through their virtual avatars. They can attend keynote speeches, panel discussions, and networking events in virtual conference halls. Attendees can interact with industry experts, explore virtual exhibition booths, and establish valuable connections in the

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financial sector. Global Finance Summit leverages the metaverse to create a global and inclusive conference experience, fostering collaboration and knowledge sharing.

- **Data Visualization and Analytics**: A company utilizes the metaverse to offer advanced data visualization and analytics tools to financial professionals. Their virtual analytics platform allows users to visualize complex financial data in interactive and immersive 3D environments. Users can explore data trends, conduct simulations, and analyze financial performance through intuitive interfaces within the metaverse. Analytics Solutions Inc. leverages the metaverse's immersive capabilities to enhance data-driven decision-making, enabling financial professionals to gain deeper insights into market trends and make informed investment decisions.

Common Risks associated:

Beyond their potential, these technologies also come with challenges such as public safety, cybersecurity, data privacy, data protection, lack of standards and technical challenges. Since they often track movements and data, massive amounts of data are generated about the whereabouts of users. It also raises questions about taxation, jurisdiction, and customer protection. Regulators and auditors have to think of the controls around privacy, data security, governance to make it more regulated.

10. CONCLUSION

Emerging technologies bring opportunities to organizations, but they also expose the enterprise to new risk. Auditors are expected to identify the right balance between cost and benefit of internal controls for mitigating these risk factors. This includes understanding how technology integrates with business, how it is governed, which activities are automated and how they are controlled, what the business impacts are as a result of this automation, and how negative impacts are controlled and monitored. Though auditors are not expected to be experts in every technology, they should be able to identify the risk inherent with these technologies. This includes understanding the technology architecture, the internal control framework embedded in the technology and its integration with business.

Key Takeaways

- A digital audit improves the quality of opinion. This consequently leads to a more reliable audit report. It leads to savings in time, cost and human effort which can be utilized towards more productive tasks.

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- Auditing digitally is using the advancements in technology for conducting an effective and efficient audit. With a rapidly growing IT environment it is essential to adapt technology in auditing practices.
- It is necessary for an auditor to understand key areas of automated environment. Such key areas include understanding flow of transaction, identification of significant systems, identification of manual and automated controls and identification of technologies used.
- It is also imperative upon an auditor to identify the risks arising from the use of IT. The auditor may consider the nature of the identified IT application.
- Applicable risks arising from the use of IT may also be identified related to cybersecurity. It is more likely that there will be more risks arising from the use of IT when the volume or complexity of automated application controls is higher, and management is placing greater reliance on those controls for effective processing of transactions or the effective maintenance of the integrity of underlying information.
- Cyber risks have to considered like a business risk. It is necessary for an auditor to understand cyber risk strategy of an entity. It should include gaining some knowledge about cybersecurity framework of an entity.
- Cybersecurity framework includes how management is identifying the risk, protecting and safeguarding its assets (including electronic assets) from the risk, management preparedness to detect the attacks, anomalies and responsiveness to the adverse event.
- Apart from having the cyber security policies, procedures, framework and regular assessment in place, management should have a strong and updated internal controls to ensure they are covered from cyber risks. Such controls could include controls over vendor setup, electronic fund transfer and patch management etc.
- Emerging technologies in business are also transforming auditing landscape. Data analytics, artificial intelligence (AI), robotic process automation, and blockchain are some of such technologies.
- Auditing digitally also has to assess technology risk considerations like relying upon programs which are inaccurately processing the data, issue of technological personnel gaining access privileges beyond those necessary to perform their duties, inability to access data as required, cybersecurity risks etc.

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Annexure I

Columnar Presentation of IND AS 16 - Property, Plant & Equipment with IFCoFR and Audit Procedures						
Para ref.	**Accounting policy**	**Relevant data to be captured**	**Relevant calculation to be made**	**Presentation in financial statements**	**IFCoFR**	**Audit procedures as per Standards on auditing**
6	Define PPE as tangible assets that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and are expected to be used during more than one period.	Identify PPE items and their cost components.	Apply recognition criteria and measurement principles.	Disclose PPE items and their carrying amounts, depreciation methods and rates, useful lives, impairment losses, etc.	Establish internal controls over the identification, recognition, measurement, depreciation, impairment, and disclosure of PPE.	Verify the existence, ownership, valuation, and disclosure of PPE by inspection, confirmation, vouching, analytical procedures, etc.
7	Recognize an item of PPE as an asset if it is probable that future economic benefits associated with the item will flow to the entity; and the cost of the item can be measured reliably.	Assess the probability and reliability of future economic benefits and cost of PPE items.	Apply cost model or revaluation model for subsequent measurement of PPE items.	Disclose the basis of recognition and measurement of PPE items.	Establish internal controls over the assessment of probability and reliability of future economic benefits and cost of PPE items.	Verify the recognition criteria and measurement basis of PPE items by inspection, confirmation, vouching, analytical procedures, etc.
8	Measure the cost of an item	Identify the cash price	Calculate the present value	Disclose the cash price	Establish internal	Verify the cash price equivalent

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	of PPE as the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, measure the cost at the present value of all future payments.	equivalent and the present value of deferred payments for PPE items.	of deferred payments using an appropriate discount rate.	equivalent and the present value of deferred payments for PPE items.	controls over the identification and calculation of cash price equivalent and present value of deferred payments for PPE items.	and present value of deferred payments for PPE items by inspection, confirmation, vouching, analytical procedures, etc.
9	Include in the cost of an item of PPE any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Exclude any costs that are not directly attributable to bringing the asset to that location and condition.	Identify the directly attributable costs and the non-attributable costs for PPE items.	Allocate the directly attributable costs to PPE items based on a rational and consistent basis. Exclude any non-attributable costs from PPE items.	Disclose the directly attributable costs and the non-attributable costs for PPE items.	Establish internal controls over the identification and allocation of directly attributable costs and non-attributable costs for PPE items.	Verify the directly attributable costs and non-attributable costs for PPE items by inspection, confirmation, vouching, analytical procedures, etc.
10	Include in the cost of an item of PPE any borrowing costs that are	Identify the borrowing costs and the qualifying	Allocate the borrowing costs to qualifying assets based	Disclose the borrowing costs and the qualifying	Establish internal controls over the identification	Verify the borrowing costs and qualifying assets for PPE items by

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	directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset in accordance with Ind AS 23 Borrowing Costs. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.	assets for PPE items.	on a rational and consistent basis.	assets for PPE items.	and allocation of borrowing costs and qualifying assets for PPE items.	inspection, confirmation, vouching, analytical procedures, etc.
11	Exclude from the cost of an item of PPE any trade discounts and rebates	Identify the trade discounts and rebates for PPE items.	Deduct the trade discounts and rebates from the cost of PPE items.	Disclose the trade discounts and rebates for PPE items.	Establish internal controls over the identification and deduction of trade discounts and rebates for PPE items.	Verify the trade discounts and rebates for PPE items by inspection, confirmation, vouching, analytical procedures, etc.
15	Recognize the cost of a self-constructed asset as the cost of an item of PPE.	Identify the self-constructed assets and their cost components.	Apply the same principles as for an acquired asset.	Disclose the self-constructed assets and their costs.	Establish internal controls over the identification and measurement of self-	Verify the self-constructed assets and their costs by inspection, confirmation, vouching, analytical procedures, etc.

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					constructed assets.	
31	Review the residual value, useful life and depreciation method of an asset at least at each financial year-end and, if expectations differ from previous estimates, account for the change as a change in an accounting estimate in accordance with Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors.	Identify the residual value, useful life and depreciation method of PPE items.	Assess whether there is any indication of change in expectations from previous estimates.	Adjust the depreciation charge accordingly and disclose the nature and effect of the change in estimate.	Establish internal controls over the review and adjustment of residual value, useful life and depreciation method of PPE items.	Verify the residual value, useful life and depreciation method of PPE items by inspection, confirmation, vouching, analytical procedures, etc.
41	Recognize the cost of replacing part of an item of PPE as an asset if it is probable that the future economic benefits embodied within the part will flow to the entity; and the cost of the	Identify the replacement parts and their costs for PPE items.	Assess the probability and reliability of future economic benefits and cost of replacement parts.	Allocate the cost of replacement parts to PPE items and remove the carrying amount of replaced parts. Disclose the replacement parts and their costs for PPE items.	Establish internal controls over the recognition and measurement of replacement parts for PPE items.	Verify the replacement parts and their costs for PPE items by inspection, confirmation, vouching, analytical procedures, etc.

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	item can be measured reliably. Derecognize the carrying amount of the replaced part.					
57	Derecognize an item of PPE on disposal or when no future economic benefits are expected from its use or disposal. Gain or loss arising from derecognition is included in profit or loss when the item is derecognized.	Identify the disposed or retired PPE items and their carrying amounts.	Calculate the gain or loss on derecognition as the difference between net disposal proceeds and carrying amount.	Recognize the gain or loss on derecognition in profit or loss. Disclose the disposed or retired PPE items and their gain or loss on derecognition.	Establish internal controls over the identification and calculation of gain or loss on derecognition of PPE items.	Verify the disposed or retired PPE items and their gain or loss on derecognition by inspection, confirmation, vouching, analytical procedures, etc.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Briefly describe the advantages and challenges of Auditing digitally.*

2. *What are the stages involved in understanding the IT environment and what key considerations auditors should consider?*

3. *Auditor should scope in ITGCs to tests when there are IT dependencies identified in the system. Briefly describe the types of IT dependencies.*

4. *What does cyber risk explain it with some examples.*

5. *Briefly describe the cyber security Framework.*

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6. *In an automated environment, the data stored and processed in systems can be used to get various insights into the way business operates. This data can be useful for the preparation of management information system (MIS) reports and electronic dashboards that give a high-level snapshot of business performance. In view of the above you are required to briefly discuss the meaning of data analytics and example of such data analytics techniques.*

7. *Enterprises are adopting emerging technologies at a rapid pace to create synergies and harness the latest technologies. Give 3 examples of automated tools used as a part of emerging technologies along with the risk and audit considerations associated with these tools.*

8. *Emerging technologies can bring great benefits, but they also come with a varied set of substantial risks. Give some examples of technology risks of digital system and the control considerations to consider while assessing technology risk.*

9. *Give examples of emerging technologies available for Next Generation Audit along with the risks associated with it.*

10. ***CA Kabir, an auditor assigned to conduct a remote audit of Beetal Limited. The audit will be conducted virtually using online platforms, with the client sharing documents and participating in video conferences. What key considerations should CA Kabir address to ensure the effectiveness and security of the remote audit?***

11. ***Certain studies have suggested that the increase in cyber-attacks and rise in global payment processing cost have hit global banking and finance industries enormously. Therefore, such industries are going to place reliance on new technologies such as Blockchain. Blockchain is based on a decentralized and distributed ledger that is secured through encryption. Each transaction is validated by the blockchain participants, creating a block of information that is replicated and distributed to all participants. However, such technology comes with its weaknesses and associated risks. What are common risks for Blockchain technology? Also discuss probable audit implications where such technology can be used.***

12. ***IT dependencies also arise due to "system generated reports" and "interfaces". How do such IT dependencies arise? Why it is important to identify IT dependencies to develop an effective and efficient audit approach?***

13. ***Mr. Karan is a consultant tasked with helping a mid-sized manufacturing company modernize its operations by integrating Internet of Things (IoT) technology. The company wants to connect various devices such as manufacturing equipment, smart home security systems for their facility, and inventory management systems. They aim to leverage IoT to improve operational efficiency, predict equipment maintenance***

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needs, and enhance overall security. However, they are concerned about the potential risks and the impact on their audit processes. Describe the key components and benefits of IoT, the risks associated with IoT implementation, and the implications for the company's audit processes. How should the company address these concerns to ensure a smooth transition?

14. ***Gravity Ltd. is a medium-sized manufacturing company that is planning to implement a new digital system to streamline its production processes and improve efficiency. The company appointed Mr. Ravi as IT manager. However, he is aware that merging technologies can bring significant benefits but also pose various risks to the organization. In this context, he needs to identify examples of technological risks associated with the implementation of the new digital system and the control considerations necessary to mitigate these risks effectively.***

15. ***Remote audit is an audit where the auditor uses online or electronic means to conduct the same. It could be partially or completely virtual, auditor engages using technology to obtain the audit evidence or to perform documentation review with the participation of the auditee. For example, an auditor might use video conferencing and cloud-based file sharing to review financial records remotely. What are the advantages and disadvantages of remote auditing?***

16. ***MNC Limited is engaged in manufacture & sale of FMCG products. It has manufacturing locations across various states in India and engages dealer channels to sell it products. One dealer is appointed for each district within the state and products are despatched from the nearest manufacturing location to the dealer. Considering the voluminous transactions, MNC Limited has a robust ERP network, for recording the transactions. As statutory auditors of MNC Ltd., your firm is about to commence the current year's audit. The audit team includes certain IT experts and discussions are underway amongst the team members. As an IT manager of the engagement team, explain the key areas for an auditor to understand IT environment.***

Answers to Test Your Understanding Questions

1. Cyber risks are not an issue of IT alone. Rather, it is a business risk and has an effect on whole business organization. It affects entity's reputation and can lead to many other consequences which are listed below: -

- Regulatory costs
- Business interruptions causing an operational challenge for an organization.

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- Data loss, reputational loss and litigation.
- Ransomware - more common these days where entire systems are encrypted
- Intellectual property theft which may not only take the competitive advantage, but we may also result in any impairment/impediment charge because of the loss of IP.
- Incident response cost which could be for investigations & remediations
- Breach of Privacy, if personal data of a consumer is hacked it could have a significant impact on the organization.
- Fines and penalties

It may happen that many cyber attacks are not directly targeted at financial systems. However, the access gained by the attackers may provide them the ability to:

- Manipulate or modify financial records
- Modify key automated business rules
- Modify automated controls relied upon by the management.

Further, auditor should consider whether cyber risk (like other business risks) represents a risk of material misstatement to the financial statement as part of the audit risk assessment activities. Focus should be on understanding the cyber risks affecting the entity and the actions being taken to address these risks.

2. (i) *Identify exceptions:* Identify exceptional transactions based on set criteria. For example, cash transactions above ₹ 10,000.

(ii) ***Identify errors:*** Identify data, which is inconsistent or erroneous. For e.g.: account number which is not numeric.

(iii) ***Verify calculations*****:** Re-perform various computations in audit software to confirm the results from application software confirm with the audit software. For e.g.: TDS rate applied as per criteria.

(iv) ***Existence of records*****:** Identify fields, which have null values. For example: invoices which do not have vendor name.

(v) ***Data completeness:*** Identify whether all fields have valid data. For example: null values in any key field such as date, invoice number or value or name.

(vi) ***Data consistency:*** Identify data, which are not consistent with the regular format. For example: invoices which are not in the required sequence.

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(vii) ***Duplicate payments:*** Establish relationship between two or more tables as required. For example, duplicate payment for same invoice.

(viii) ***Accounts exceeding authorized limit:*** Identify data beyond specified limit. For example, transactions entered by user beyond their authorized limit or payment to vendor beyond amount due or overdraft allowed beyond limit.

3. RPA can be used to streamline hiring process in a company. The tentative steps could include: -

- Place advertisements on social media/career advice sites.
- Link redirects candidate to a career site.
- Career site pulls information of candidate.
- An algorithm scans applicants for desired and suitable roles.
- Selected candidates may be asked to play online games to assess their skills.
- A certain percentage of those applicants are called for a video interview using an interview software.

The automated hiring process will reduce full time effort involvement, provide with a wider assessment range, reduce the impact of recruiter biases, increase the efficiency of mapping of interested candidates, reduce recruiting costs, increase hire yield, reduce time to hire, increase diversity.

Hints /Answers to Theoretical Questions:

1. Advantages – Improved efficiency, better quality, lower costs, improved risk assessment.

Challenges – Reluctance to change, challenges with data security and governance, choosing the right tool and automating the right process, ensuring standardisation and correct configurations to avoid error and bias, evaluating business benefits the organization wants to achieve with automation and the roadmap for digital strategy.

For details refer to Para 2.

2. The stages involved in understanding of IT environment are: Understand – Identify – Assess.

Key considerations - Understand the flow of transaction, Identification of Significant Systems, Identification of Manual and Automated Controls, Identification of the technologies used and. Assessing the complexity of the IT environment.

For details refer Para 3.

3. Refer para 4.

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4. Refer para 5.1.

5. Refer para 5.3.

6. Refer para 6.

7. Refer para 7.

8. Refer para 8.

9. Refer para 9.

10. Refer Para 5.5.

11. Refer Para 7.3.

12. IT dependencies are created when IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in the financial statements.

System generated reports are the information generated by the IT systems. These reports are often used in an entity's execution of a manual control, including business performance reviews, or may be the source of entity information used by us when selecting items for the testing, performing substantive tests of details or performing a substantive analytical procedure. e.g. (Vendor master report, customer ageing report).

Interfaces are programmed logic that transfer the data from one IT system to another. For example, an interface may be programmed to transfer data from a payroll subledger to the general ledger.

In this manner, IT dependencies arise due to "system generated reports" and "interfaces".

Identifying and documenting the entity's IT dependencies in a consistent, clear manner helps to identify the entity's reliance upon IT, understand how IT is integrated into the entity's business model, identify potential risks arising from the use of IT, identify related IT General Controls and enables us to develop an effective and efficient audit approach.

13. Refer Para 7.1.

14. Refer Para 8. Further Mr. Ravi should focus on the following control considerations to mitigate risks effectively:

1. Auditors should gain a holistic understanding of changes in the industry and the information technology environment to effectively evaluate management's process

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for initiating, processing, and recording transactions and then design appropriate auditing procedures.

2. *Auditors, as appropriate, should consider risks resulting from the implementation of new technologies and how those risks may differ from those that arise from more traditional, legacy systems.*

3. *Auditors should consider whether digital upskilling or specialists are necessary to determine the impact of new technologies and to assist in the risk assessment and understanding of the design, implementation, and operating effectiveness of controls. E.g., cybersecurity control experts, IT specialists in the team etc.*

15. Refer Para 5.5.

16. Refer Para 3.1.

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CHAPTER 13

GROUP AUDITS



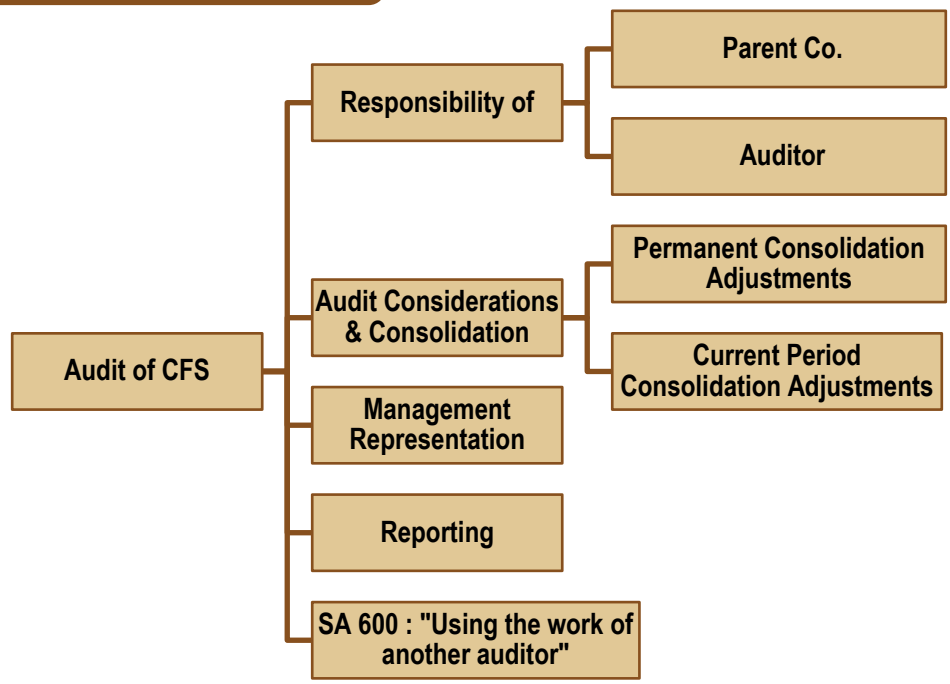
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the concept of Audit of Consolidated Financial Statements.
- Identify the responsibility of Parent and Auditor in Consolidation of Financial Statements.
- Gain the knowledge of Audit Considerations during the Audit of Consolidated Financial Statements.
- Recognise the manner of Permanent Consolidation Adjustment and Current Period Consolidation Adjustments.
- Learn the reporting requirements as per the given circumstance and understand audit of group financial statements including the work of component auditors.
- Understand and interpret SA 600, "Using the Work of Another Auditor".

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CHAPTER OVERVIEW



CA Mudit is the statutory auditor of a manufacturing company whose financial statements are required to be prepared in accordance with Ind-AS. At the time of planning the audit for the current year, he noticed that the company had purchased shares of another company located in the USA. He further inquired from the management and found that all shares of US based company were purchased by Indian company.

Section 129 of the Companies Act, 2013, immediately came to his mind. Whether provisions regarding consolidation of financial statements would apply in such a case? Since Indian company has acquired all shares of another company, aren't its financial statements required to be consolidated? Gathering further insight, it became clear to him that financial statements of Indian company are required to be consolidated as it has a wholly owned subsidiary now.

Mudit also had another recurring concern. Whether foreign subsidiaries are covered within scope of consolidated financial statements? An in-depth reading of Ind AS 110 on *"Consolidated financial statements"* provided clarity and it became clear to him that a parent which presents consolidated financial statements should consolidate all subsidiaries, domestic as well as foreign. The management of the company was informed to prepare the

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groundwork for the preparation of consolidated financial statements in accordance with statutory provisions and applicable accounting standards.

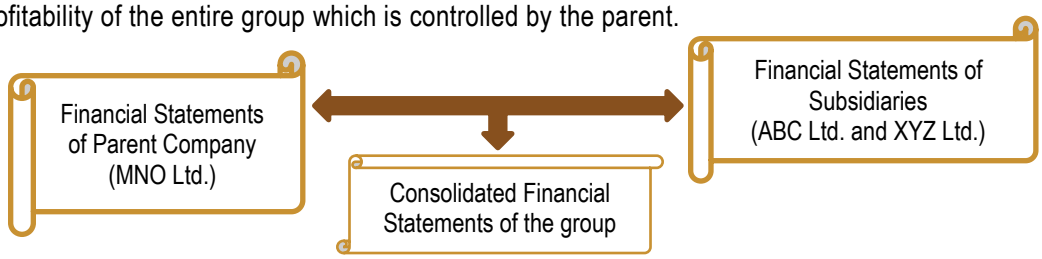
While consolidating financial statements, management was caught in a dilemma. The financial statements were going to be consolidated for the first time. However, the Indian parent company had acquired all shares in foreign subsidiary in the month of June. The question arose as to from which date consolidation is required. Is it required for the whole year or from the date of acquiring shares in foreign subsidiary? Referring to Ind AS 110, the management learned that the results of the operations of a subsidiary are included in the consolidated financial statements from the date on which the parent gained control of the subsidiary.

The management prepared consolidated financial statements by combining like items of assets, liabilities, income and expenses of the parent with that of a foreign subsidiary. There was no minority interest involved.

While auditing such group financial statements prepared by the management, Mudit discovered that the foreign subsidiary's accounts were unaudited. This put him in a Catch-22 situation. How should he proceed? What are the implications for unaudited accounts of a component included in the group financial statements? What considerations should he take into account in such a case?

1. INTRODUCTION

Consolidated Financial Statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. In other words, consolidated financial statements present the financial position of an entire group including the parent and its group companies. Whereas separate financial statements present the financial position of a single entity for which the financial statements are prepared. Consolidated financial statements provide a complete overview of the operations and profitability of the entire group which is controlled by the parent.

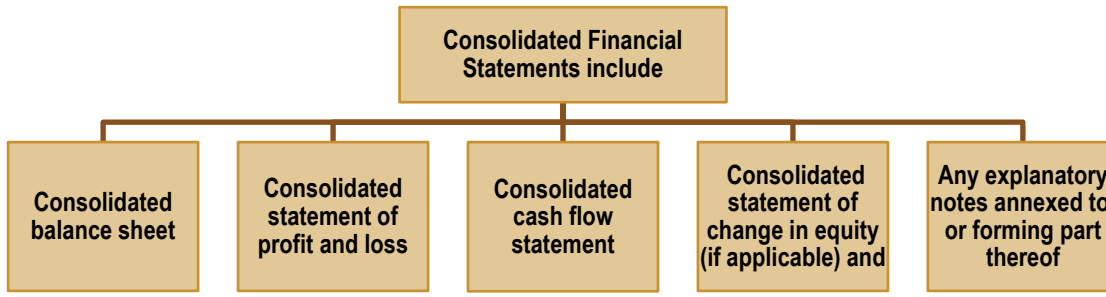


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In the above diagram there is one parent company (MNO Ltd.) having two subsidiaries (ABC Ltd. and XYZ Ltd.) The auditor of MNO Ltd. is SS Maheshwari & Co. while the auditor of ABC Ltd. and XYZ Ltd. is RT & Associates. Further, it was decided that SS Maheshwari & Co. will act as the principal auditor (i.e., auditor with reporting responsibilities with respect to the consolidated financial statements of the group). Now the management of all the three companies is responsible for preparation of their respective standalone financial statements which shall then be audited by the respective auditors. Thereafter, the parent company shall prepare the consolidated financial statements for the group. Once the consolidated financial statements are prepared, such financial statements are audited by the principal auditor. Now, we need to consider the following points.

- The responsibility of the parent company in consolidation of financial statements. (MNO Ltd.)
- Manner of permanent adjustment and current period consolidation adjustment.
- The principal auditor's procedures. (SS Maheshwari & Co.)
- Coordination and division of responsibility between both the auditors.
- Reporting requirements.

Consolidated financial statements are presented, to the extent possible, in the same format as adopted by the parent for its separate financial statements. The formats for preparation of balance sheet, statement of profit and loss and a statement of change in equity (if applicable) are prescribed under the Schedule III of the Companies Act, 2013.



An entity which prepares the consolidated financial statements, either under any law or regulation governing the entity or *suo motu*, might be required to or otherwise engage the auditor for conducting the audit of consolidated financial statements. However, a law or regulation governing the entity may require the consolidated financial statements to be audited by the statutory auditor of the entity (i.e. the auditor who audits standalone financial statements of the entity). The Guidance Note on Audit

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of Consolidated Financial Statements provides guidance on the specific issues and audit procedures to be applied in an audit of consolidated financial statements. This Guidance Note can also be used while auditing consolidated financial statements prepared for special purposes, to the extent applicable but it does not deal with accounting matters arising on consolidation of financial statements.

Accounting Standard (AS) 21, 'Consolidated Financial Statements' and Indian Accounting Standard (Ind AS) 110, 'Consolidated Financial Statements' lay down principles and procedures for preparation and presentation of consolidated financial statements under AS and Ind AS respectively. In other words, whenever a parent decides to or is required to prepare and present consolidated financial statements, it should do so in accordance with the requirements of applicable Accounting Standards under the relevant financial reporting framework

1.1 Consolidation of Financial Statements - Mandatory under the Companies Act, 2013

According to Section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, including associate company and joint venture, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own. Further, section 129(4) of the said Act, provides that the provisions applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, also apply to its the consolidated financial statements.

The consolidated financial statements shall also be approved by the Board of Directors before they are signed on behalf of the Board, along with its standalone financial statements and shall also be laid before the annual general meeting of the company along with the laying of its standalone financial statement.

The company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary(ies) in Form AOC-1.

According to the Companies (Accounts) Rules, 2014, the consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III to the Act and the applicable accounting standards. However, a company which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions of consolidated financial statements provided in Schedule III of the Act.

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However, the requirement related to preparation of consolidated financial statements shall not apply to a company if it meets the following conditions:	
(i)	it is a wholly-owned subsidiary, or is a partially-owned subsidiary of another company and all its other members, including those not otherwise entitled to vote, having been intimated in writing and for which the proof of delivery of such intimation is available with the company, do not object to the company not presenting consolidated financial statements;
(ii)	it is a company whose securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; and
(iii)	its ultimate or any intermediate holding company files consolidated financial statements with the Registrar which are in compliance with the applicable Accounting Standards.

As per sub-section 6 of the section 129 of the Companies Act, 2013, the Central Government may, on its own or on an application by a class or classes of companies, by notification, exempt any class or classes of companies from complying with any of the requirements of section 129 or the rules made thereunder, if it is considered necessary to grant such exemption in the public interest and any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

Thus, the companies having subsidiaries, which have previously never prepared the consolidated financial statements, must prepare their consolidated financial statements in adherence with this mandatory requirement. This will provide the holding companies' stakeholders with more transparency about the companies' businesses.

Further, an investment entity need not present consolidated financial statements if it is required, in accordance with paragraph 31 of Ind AS 110, to measure all its subsidiaries at fair value through profit or loss. A parent shall determine whether it is an investment entity.

An investment entity is an entity that:

(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;	(b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and	(c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

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However, as per paragraph 33 of Ind AS 110, the parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

Case Study - Consolidation of Financial Statement of a Subsidiary

1. Parent Ltd acquired 51% shares of Child Ltd during the year ended 31-3-2024. During the financial year 2023-24, 20% shares of Child Ltd were sold by Parent Ltd. Parent Ltd while preparing the financial statements for the year ended 31-3-2023 and 31-3-2024 did not consider the financial statements of Child Ltd for consolidation. As a statutory auditor how would you deal with it?

Provisions & Explanation: As per Ind AS 110, there is no such exemption for 'temporary control', or "for operation under severe long-term funds transfer restrictions" and consolidation is mandatory for Ind AS compliant financial statement in this case.

However, as per section 129(3) of the Companies Act, 2013 where a company having subsidiary, which is not required to prepare consolidated financial statements under the applicable Accounting Standards, it shall be sufficient if the company complies with the provisions of consolidated financial statements provided in Schedule III to the Act.

Conclusion: In the given case, Parent Ltd acquired 51% shares of Child Ltd during the year ended 31.03.2023 and sold 20% shares during the year ended 31.03.2024. Parent Ltd did not consolidate the financial statements of Child Ltd for the year ended 31.03.2023 and 31.03.2024.

The intention of Parent Ltd is quite clear that the control in Child Ltd is temporary as the former company disposed off the acquired shares in the next year of its purchase. Parent Ltd is required to prepare Consolidated Financial Statements in accordance with Ind AS 110 as exemption for 'temporary control', or "for operation under severe long-term funds transfer restrictions" is not available under Ind AS 110. Paragraph 20 of Ind AS 110 states that "Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee".

2. RESPONSIBILITY OF PARENT

The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent. This includes:

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(a)	identifying components, and including the financial information of the components to be included in the consolidated financial statements;
(b)	where appropriate, identifying reportable segments for segmental reporting;
(c)	identifying related parties and related party transactions for reporting;
(d)	obtaining accurate and complete financial information from components;
(e)	making appropriate consolidation adjustments;
(f)	harmonization of accounting policies and accounting framework; and
(g)	GAAP conversion, where applicable.

Apart from the above, the parent ordinarily issues instructions to the management of the component specifying the parent's requirements relating to financial information of the components to be included in the consolidated financial statements. The instructions ordinarily cover the accounting policies to be applied, statutory and other disclosure requirements applicable to the parent, including the identification of and reporting on reportable segments, related parties and related party transactions, and a reporting timetable.

3. RESPONSIBILITY OF THE AUDITOR OF THE CONSOLIDATED FINANCIAL STATEMENTS



Fig.: Responsibility of Auditors*

Section 129(4) of the Companies Act, 2013 requires that the provisions of the Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements. Besides other matters, the principal auditor of the consolidated financial statements is responsible for expressing an opinion on whether the consolidated financial statements are prepared, in all material respects, in accordance with the financial reporting framework under which the parent prepares the consolidated financial statements in addition to reporting on the additional matters as required under the Companies Act, 2013 and any other statute to the extent applicable.

Therefore, the auditor's objectives in an audit of consolidated financial statements are:

(a) to satisfy himself that the consolidated financial statements have been prepared in accordance with the requirements of the applicable financial reporting framework;

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(b) to enable himself to express an opinion on the true and fair view presented by the consolidated financial statements;

(c) to enquire into the matters as specified in section 143(1) of the Companies Act, 2013; and.

(d) to report on the matters given in the clauses (a) to (i) of section 143(3) of the Companies Act, 2013 for other matters under section 143(3)(j) read with rule 11 of the Companies (Audit and Auditors) Rules, 2014, to comment on the matters specified in sub-rule (a),(b), (c), (d), (e), (f) and (g)[1] to the extent applicable;

(e) The auditor should also validate the requirement of preparation of CFS for the company as per applicable financial reporting framework.

Standards on Auditing, Statements and Guidance Notes on auditing matters issued by the Institute of Chartered Accountants of India (ICAI) apply in the same manner to audit of consolidated financial statements as they apply to audit of standalone financial statements. It means that the auditors, while conducting the audit of consolidated financial statements are, *inter alia,* expected to:

(a) plan their work to enable them to conduct an effective audit in an efficient and timely manner;

(b) obtain an understanding of the accounting and internal control systems including IT system like consolidation tool, sufficient to plan the audit and determine the nature, timing and extent of his audit procedures. Such an understanding would help the auditors to develop an effective audit approach;

(c) use professional judgement to assess audit risk and to design audit procedures to ensure that the risk is reduced to an acceptable level, etc.

4. AUDIT CONSIDERATIONS

The following features of consolidated financial statements have an impact on the related audit procedures:

(a) The consolidated financial statements are prepared on the basis of separate financial statements of the parent and its components, using the consolidation procedures prescribed by Accounting Standards[2] under applicable financial reporting framework; and

[1] The auditor of the consolidated financial statements generally reports on the matters pertaining to the component, on the basis of auditors' report of the respective component.

[2] Accounting Standard (AS) 21, Consolidated Financial Statements, Accounting Standard (AS 23)- Accounting for Investments in Associates in Consolidated Financial Statements and Accounting Standard (AS) - 27, Financial Reporting

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(b) The auditor of the consolidated financial statements may use the work of other auditors as per requirement of Standards on Auditing unless the auditor of consolidated financial statements is also the auditor of the other components of the group.

The consolidated financial statements (including the intermediate consolidated financial statements prepared internally)[3] are prepared using the separate financial statements of the parent and its components and also other financial information, which might not be covered by the separate financial statements of these entities. The 'other financial information' would include disclosures to be made in the consolidated financial statements about the components, proportion of items included in the consolidated financial statements to which different accounting policies have been applied where permitted, adjustments made for the effects of significant transactions or other events that occur between the financial statements of parent and its components, as the case may be, etc. Thus, this 'other financial information' would be required to be additionally disclosed.

When an auditor accepts the audit of consolidated financial statements, the auditor should assess whether based on his work alone he would be able to express an opinion on the true and fair view presented by the consolidated financial statements. If the auditor is of the view that his own participation may not be enough or sufficient, he should consider using the work of 'other auditors'.

Consolidation – Example

- Group consists of entity A and its subsidiaries B and C
- B has a loan with A of 100

	A	B	C	Total	Eliminations	Group
PPE	100	50	30	180		180
Shares in subsidiaries	500	-	-	500	-500-	-
Intercompany receivables	100	-	-	100	-100	-
Receivables	-	400	300	700	-	700
Intercompany debt	-	-100	-	-100	100	-
Debt	-100	-50	-130	-280		-280
Equity	-600	-300	-200	-1,100	500	-600

of Interests in Joint Ventures OR Indian Accounting Standard (Ind AS) 110 – Consolidated Financial Statements, Indian Accounting Standard (Ind AS) 111- Joint Arrangements, Indian Accounting Standard (Ind AS) 112 –Disclosure of Interests in Other Entities and Indian Accounting Standard (Ind AS) 28 – Investments in Associates and Joint Ventures.

[3] Intermediate consolidated financial statements are the consolidated financial statements of an intermediate parent, e.g., Company A has one subsidiary Company B. Company B has a subsidiary Company C. In this case, Company B is the intermediate parent and the consolidated financial statements prepared by Company B will be intermediate consolidated financial statements.

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Such 'other auditors' might be the statutory auditors of the separate financial statements of one or more of the components or the auditors appointed specifically for assisting the auditor of the consolidated financial statements (the principal auditor).

Where the statutory auditors of one or more of the components of the parent are also requested to assist the principal auditor, the work to be performed by such statutory auditors for use by the principal auditor would constitute an assignment separate from the assignment to conduct the statutory audit of the respective component.

Standard on Auditing (SA) 600, 'Using the Work of Another Auditor' establishes standards when an auditor, reporting on the financial statements of an entity (the group—in the case of consolidated financial statements), uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity (Paragraph 2 of SA 600). The principal auditor, if he decides to use the work of another auditor in relation to the audit of consolidated financial statements, should comply with the requirements of SA 600.

In carrying out the audit of the standalone financial statements, the computation of materiality for the purpose of issuing an opinion on the standalone financial statements of each component would be done component-wise on a standalone basis. However, with regard to determination of materiality during the audit of consolidated financial statements (CFS), the auditor should consider the following:

- The auditor is required to compute the materiality for the group as a whole. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e. permanent consolidation adjustments and current period consolidation adjustments) that are made by the management in the preparation of CFS.
- The parent auditor can also use the materiality computed on the group level to determine whether the component's financial statements are material to the group to determine whether they should scope in additional components and consider using the work of other auditors as applicable.
- The principal auditor also computes the materiality for each component and communicates to the component auditor, if he believes is required for a true and fair view on CFS.
- The principal auditor also obtains certain confirmations from component auditors like independence, code of ethics, certain information required for consolidation and disclosure requirements etc.

However, while considering the observations (for instance modification and /or emphasis of matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the principles of SA 600 need to be considered. ICAI issued an announcement dated

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May 25, 2017 which amended paragraph 17 of Guidance Note and states that while considering the observations (for instance modification and /or emphasis of matter/other matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the parent auditor should comply with the requirements of SA 600, "Using the Work of Another Auditor". Therefore, the concept of materiality would be considered while considering the observations of the component auditor.

5. AUDITING THE CONSOLIDATION

Before commencing an audit of consolidated financial statements, the auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner.

The auditor should make plans, among other things, for the following:

(a)	Understanding of the group structure and group-wide controls including assessment of Information Technology (IT) system and related general and applications IT related controls (manual and automated) for consolidation process;
(b)	understanding of accounting policies of the parent and its components as well as of the consolidation process including the process of translation of financial statements of foreign components;
(c)	determining and programming the nature, timing, and extent of the audit procedures to be performed based on the assessment of the risk of material misstatement in consolidation process;
(d)	determining the extent of use of other auditor's work in the audit; and
(e)	coordinating the work to be performed.

A parent which presents consolidated financial statements is required to consolidate all its components in the consolidated financial statements other than those for which exceptions have been provided in the relevant accounting standards under the applicable financial reporting framework.

The auditor should obtain a listing of all the components included in the consolidated financial statements and review the information provided by the management of the parent's identifying the components. The auditor should verify that all the components have been included in the consolidated financial statements unless these components meet the criterion for exclusion.

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In respect of completeness of this information, the auditor should perform the following procedures:

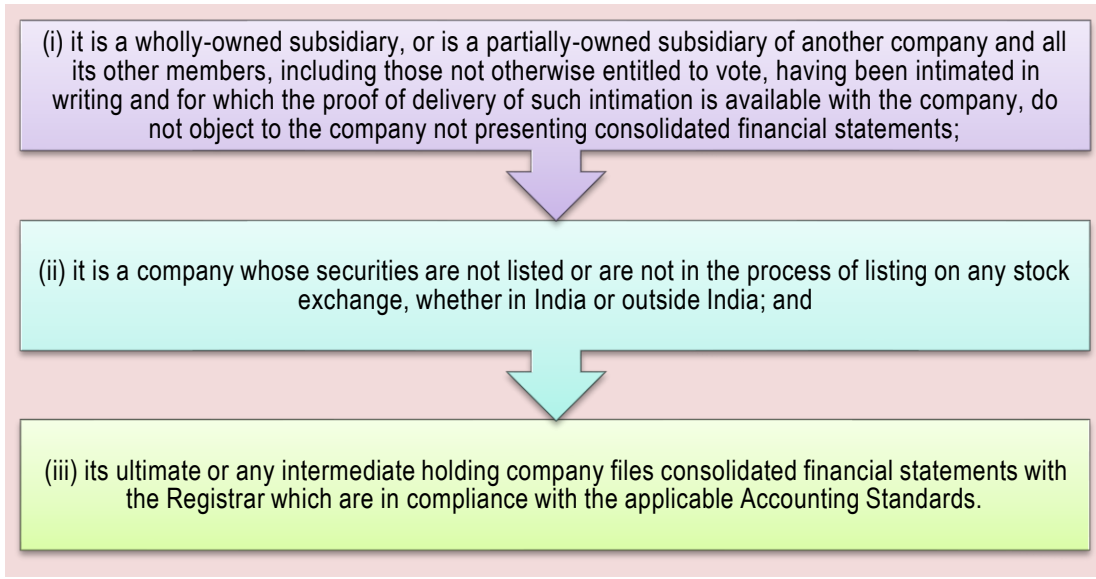
(a)	review his working papers for the prior years for the known components;
(b)	review the parent's procedures for identification of various components;
(c)	make inquiries of the management to identify any new components or any component which goes out of consolidated financial statements;
(d)	review the investments of parent as well as its components to determine the shareholding in other entities;
(e)	review the joint ventures and joint arrangements as applicable;
(f)	review the other arrangements entered into by the parent that have not been included in the consolidated financial statements of the group;
(g)	review the statutory records maintained by the parent, for example registers under section 186, 190 of the Companies Act, 2013;
(h)	identify the changes in the shareholding that might have taken place during the reporting period.

The auditor should document procedures performed for assessing the completeness of the components to be consolidated.

There would be various means by which control, joint control or significant influence can be obtained. In this regard, the auditor may verify the Board's minutes, shareholder agreements entered into by the parent, agreements with the entities to which the parent might have provided any technology or know-how, enforcement of statute, as the case may be, etc. The auditor may also review the minutes of the meetings of the Board of Directors subsequent to the year-end to understand if there has been any liquidation of investments or any further investments have been made as these may provide further evidence to understand if the control was meant to be temporary in nature or otherwise.

Where a component is excluded from the consolidated financial statements, the auditor should examine the reasons for exclusion and whether such exclusion is in conformity with the applicable financial reporting framework, for example, under the Companies (Accounting Standards) Rules, 2006, there could be two reasons for exclusion of a subsidiary, associate or jointly controlled entity - one, that the relationship of parent with the subsidiary, associate or jointly controlled entity is intended to be temporary or the subsidiary, associate or joint venture operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent. Similarly, under the Companies Act, 2013, intermediate subsidiary in India is not required to present consolidated financial statements, if a company meets the following conditions:

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Ind AS 110 also prescribes certain criteria where consolidated financial statements are not required. In such cases, the auditor should satisfy himself that the exclusion made by the management falls within these categories, example in the case of an entity which is excluded from consolidation on the ground that the relationship of parent with the other entity as subsidiary, associate or joint venture is temporary, the auditor should verify that the intention of the parent, to dispose off the subsidiary, investment in associate or interest in jointly controlled entity, in the near future, existed at the time of acquisition of the subsidiary, making investment in associate or jointly controlled entity. The auditor should also verify that the reasons for exclusion are given in the consolidated financial statements. If an entity is excluded from the consolidated financial statements for reasons other than those allowed by the applicable financial reporting framework, the auditor should consider its effect on the auditor's report to be issued.

The auditor should also examine whether there is any change in the status of a component (e.g., subsidiary to associate, JV to associate or vice – versa). The auditor, in such cases, should examine whether these changes have been appropriately accounted for in the consolidated financial statements as required by the relevant accounting standards/Ind AS under the applicable financial reporting framework.

(a) In preparing consolidated financial statements in accordance with the Companies (Accounting Standards) Rules, 2006, the financial statements of the parent and its subsidiaries are combined on a line-by-line basis by adding together like items of assets, liabilities, income, expenses and cash flows and then certain calculations like determination of goodwill or capital reserve, minorities interest and adjustments like

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	elimination of intra group transactions, balances and unrealised profits etc. are made in accordance with the requirements of Accounting Standard (AS) 21, "Consolidated Financial Statements". Investments in associates are accounted for using the Equity Method as prescribed in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements". A parent that has an interest in a jointly controlled entity, reports its interest in the consolidated financial statements using proportionate consolidation method in accordance with Accounting Standard (AS) 27, "Financial Reporting of Interests in Joint Ventures". Many of the procedures appropriate for the application of equity method and the proportionate consolidation method are similar to the consolidation procedures set out in Accounting Standard (AS) 21, "Consolidated Financial Statements".
(b)	**For consolidation of subsidiaries in accordance with the Companies (Indian Accounting Standards) Rules, 2015:** • the financial statements of the parent and its subsidiaries are combined as per Ind AS 110, "Consolidated Financial Statements" on a line-by-line basis by adding together like items of assets, liabilities, income, expenses and cash flows; • related goodwill/ capital reserve (or gain on bargain purchase) and non-controlling interest is determined as per Ind AS 103; • business combinations involving entities or businesses under common control shall be accounted for using the pooling of interest method in accordance with Ind AS 103; • adjustments like elimination of intra-group transactions, balances, unrealised profits and deferred tax etc. are made in accordance with the requirements of Ind AS 110; • investments in associates and joint ventures are accounted for using the Equity Method as prescribed in Indian Accounting Standard (Ind AS) 28, "Investments in Associates and Joint Ventures". Interests in assets, liabilities, revenues and expenses in a joint operation are accounted for as part of separate financial statements of the entity in accordance with Indian Accounting Standard (Ind AS) 111, "Joint Arrangements"; • in a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate in accordance with Ind AS 103.

The auditor should verify that the adjustments warranted by the relevant accounting standards under the applicable financial reporting framework have been made wherever required and have been properly approved by the management of the parent. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period consolidation

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adjustments. The auditor should also pay attention to off balance sheet entities which sometimes do not qualify for the definition of subsidiary, however, parent might have transferred risks of various business ventures to these entities. Further, de-facto control should also be considered.

De facto control means an investor with less than the majority of the voting rights has the practical ability to direct the relevant activities unilaterally.

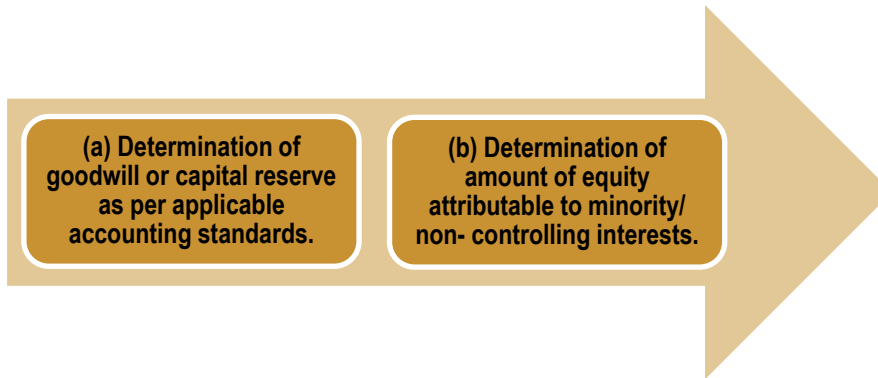
TEST YOUR UNDERSTANDING 1

CA. Mukund is in the second year of his term as statutory auditor of Style Marks Limited (Holding company), its subsidiaries and joint ventures. At the time of planning the audit, he wants to be sure that all the components have been included in the consolidated financial statements. List out some procedures he should perform to verify completeness of this information.

6. SPECIAL CONSIDERATIONS

6.1 Permanent Consolidation Adjustments

Permanent consolidation adjustments are those adjustments that are made only on the first occasion or subsequent occasions in which there is a change in the shareholding of a particular entity which is consolidated. Permanent consolidation adjustments are:



The auditor should verify that the above calculations have been made appropriately.

- The auditor should pay particular attention to the determination of pre-acquisition reserves of the components. Date(s) of investment in components assumes importance in this regard.
- The auditor should also examine whether the pre-acquisition reserves have been allocated appropriately between the parent and the minority interests/ non-controlling interests of the subsidiary.

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- The auditor should also verify the changes that might have taken place in these permanent consolidation adjustments on account of subsequent acquisition of shares in the components, disposal of the components in the subsequent years.

It may happen that while working out the permanent consolidation adjustments, in the case of one subsidiary, goodwill arises and in the case of another subsidiary, capital reserve arises. The parent may choose to net off these amounts to disclose a single amount in the consolidated balance sheet where permitted by the applicable financial reporting framework. In such cases, the auditor should verify that the gross amounts of goodwill and capital reserves arising on acquisition of various subsidiaries have been disclosed in the notes to the consolidated financial statements to reflect the excess/shortage over the parents' portion of the subsidiary's equity.

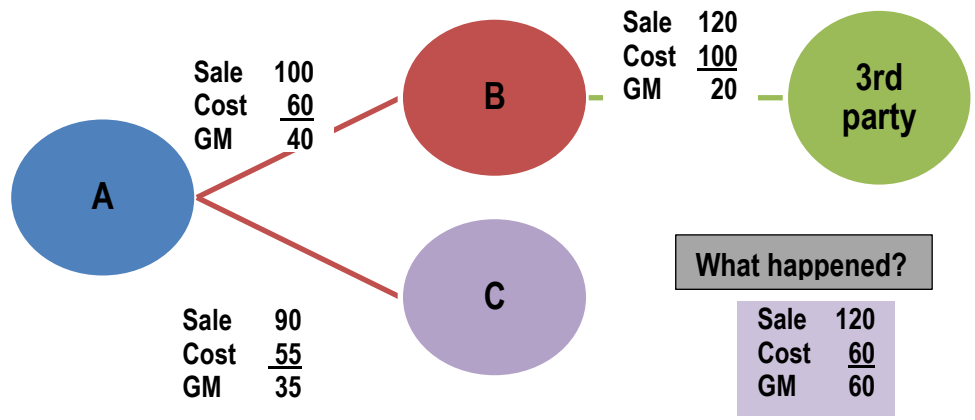
example

XYZ Ltd. is a company engaged in the manufacture of tyres for four wheelers and two wheelers through its subsidiaries ABC Ltd. and MNO Ltd. The company has invested 70% in ABC Ltd. During the FY 2023-24, the company reduced the control over ABC Ltd. from 70% to 55%. Consequently, certain adjustments were made to the accounts for the change in share of equity held in XYZ Ltd. whose financials are being consolidated. Such kind of adjustments are known as permanent consolidation adjustments.

6.2 Current Period Consolidation Adjustments

Current period adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done.

Consolidation – Elimination of inter-company purchases as sales



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Current period consolidation adjustments primarily relate to the elimination of intra-group transactions and account balances including:

(a) intra-group interest paid and received, or management fees, etc.;

(b) unrealised intra-group profits on assets acquired/ transferred from/ to other subsidiaries;

(c) record deferred taxes on unrealised intercompany profits elimination in accordance with Ind AS 12;

(d) intra-group indebtedness;

(e) adjustments related to harmonising the different accounting policies being followed by the parent and its components;

(f) adjustments to the financial statements (of the parent and the components being consolidated) for recognized subsequent events or transactions that occur between the balance sheet date and the date of the auditor's report on the consolidated financial statements of the group.

There are two types of subsequent events:

(i) The first type of subsequent events consists of events or transactions that provide additional evidence about conditions that existed at the date of the financial statements, including the estimates inherent in the process of preparing financial statements (i.e. adjusting events).

(ii) The second type of subsequent events consists of events that provide evidence about conditions that did not exist at the date of the financial statements but arose subsequent to that date (i.e. non-adjusting events).

Events occurring after balance sheet date which do not require adjustments would not normally require disclosure, although they may be of such significance that they may require a disclosure in the report of approving authority in the case of accounting standards and in the financial statements in case of Ind AS. For such events, the following shall be disclosed:

(i)	The nature of the event; and
(ii)	An estimate of its financial effect or a statement that such an estimate cannot be made.

(g) adjustments for the effects of significant transactions or other events that occur between the date of the components balance sheet and not already recognised in its financial statements and the date of the auditor's report on the group's consolidated financial statements when

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the financial statements of the component to be used for consolidation are not drawn upto the same balance sheet date as that of the parent;

(h) In case of a foreign component, adjustments to convert a component's audited financial statements prepared under the component's local GAAP to the GAAP under which the consolidated financial statements are prepared;

(i) determination of movement in equity attributable to the minorities interest/non-controlling interest since the date of acquisition of the subsidiary. It should also be noted that under Ind AS, non-controlling interest can also result in negative balance. Unlike earlier AS, as per paragraph 28 of Ind AS 27, if the net worth of subsidiary is negative, non-controlling interest could have deficit balance;

(j) adjustments of deferred tax on account of temporary differences arising out of elimination of profit and losses resulting from intragroup transactions and undistributed profits of the component in case of consolidated financial statements prepared under Ind AS.

The adjustments required for preparation of consolidated financial statements are made in memorandum records kept for the purpose by the parent. The auditor should review the memorandum records to verify the adjustment entries made in the preparation of consolidated financial statements.

Apart from reviewing the memorandum records, the auditor should inter alia:	
(a)	verify that the intra group transactions and account balances have been eliminated;
(b)	verify that the consolidated financial statements have been prepared using uniform accounting policies for like transactions and other events in similar circumstances;
(c)	verify that adequate disclosures have been made in accordance with AS 21 in the consolidated financial statements of application of different accounting policies in case, it was impracticable to harmonize them. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so[4] but while preparing CFS under Ind AS, auditors should ensure that appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies in accordance with Ind AS 110;

[4] AS 21/ AS 23/ AS 27 permit application of different accounting policies, if it is impractical to use uniform accounting policies, that fact should be disclosed together with the proportion of the items in the consolidated financial statements to which the different accounting policies have been applied. Ind AS 28 permits that financial statement of an associate can be prepared using different accounting policies if it is impractical to do so however adjustment shall be made to make the accounting policies confirm to those of parent when the financial statements are used by parent in applying the equity method.

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(d)	verify the adjustments made to harmonise the different accounting policies including adjustments made by management to convert a component's financial statements prepared under the component's GAAP to the GAAP under which the consolidated financial statements are prepared;
(e)	verify the calculation of minorities/non-controlling interest;
(f)	verify adjustments relating to deferred tax on account of temporary differences arising out of elimination of profit and losses resulting from intergroup transactions (where the parent's accounts are maintained in Ind AS);
(g)	verify that income and expenses of the subsidiary are included in consolidated financial statements from the date it gains control until the date when the entity ceases to control the subsidiary and further such income and expenses are based on the amounts of the assets and liabilities recognised in consolidated financial statements at the acquisition date[5].

The auditor should gain an understanding of the procedures adopted by the management of the enterprise to make the above-mentioned adjustments. This helps the auditor in reducing the audit risk to an acceptably low level.

One of the important adjustments that may be required in the current period is determination of impairment loss that might exist for goodwill arising on consolidation. Goodwill arising on consolidation is carried at the value determined at the date of acquisition of the component, and the same is to be tested for impairment loss at every balance sheet date.

The auditor should examine whether any impairment loss has been determined by the parent. If yes, the auditor should examine the procedure followed for determination of impairment loss. The auditor should satisfy himself that the amount of impairment loss determined is fair. In case the impairment loss in goodwill of a component has been determined in foreign currency, the auditor should verify if any amount of loss in local currency need to be adjusted from currency translation reserve on account of movement in the exchange rate from the date when the goodwill was first accounted for in the consolidated financial statement of parent, to the date of determination of impairment loss.

The auditor should also perform audit procedures to understand and verify whether intragroup losses are indicating an impairment loss that requires recognition in the consolidated financial statements.

Apart from verifying that the calculation and disclosures regarding minorities/non-controlling interest have been made appropriately, the auditor also determines, in cases where the minority interests' share of the losses exceed the minority/non-controlling interests' share of the equity, the excess, and any further losses applicable to the minority interest, have been accounted for in accordance with the relevant accounting standards.

[5] Where the consolidated financial statements are prepared under Indian Accounting Standards.

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The financial statements of the components used in the consolidation should be drawn up to the same reporting date as that of the parent. If it is not practicable to draw up the financial statements of one or more components to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months in case of financial statements under AS and three months in case of financial statements under Ind AS. The auditor of the consolidated financial statements should review other components' results between its financial reporting date and that of the parent for significant transactions or other events that have taken place during the period and, therefore, need to be reflected in the consolidated financial statements. Recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position, results of operations or cash flows.

The fundamental accounting assumption of "consistency" requires the auditor of the consolidated financial statements to consider whether the length of the reporting periods and any difference in financial year-ends are the same from period to period. If there have been any changes in the respective reporting periods of the components included in the consolidated financial statements that have a material effect on the financial statements, the auditor should ensure that the entity discloses such changes and the manner of treatment in the financial statements.

The Ministry of Corporate Affairs has issued a Circular number 39/2014 dated October 14, 2014 stating that Schedule III to the Act read with the applicable Accounting Standards does not envisage that a company while preparing its consolidated financial statements merely repeats the disclosures made by it under separate financial statements being consolidated. In the consolidated financial statements, the company would need to give all disclosures relevant to consolidated financial statements only.

Further, Accounting Standard (AS) 21 also lays down certain principles that should be observed while giving the information which is part of the separate financial statements of the Components but that need not be reported in the notes and other explanatory material of the consolidated financial statements.

The auditor should:

(a) examine that the notes required by the applicable standards which are necessary for presenting a true and fair view of the consolidated financial statements have been included in the consolidated financial statements as an integral part thereof; and

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(b) examine that additional statutory information disclosed in the separate financial statements of the subsidiary and/or a parent having bearing on the true and fair view of the consolidated financial statements have been disclosed in the consolidated financial statements.

In addition, the information required pursuant to Schedule III to the Companies Act, 2013 ('general instructions for the preparation of consolidated financial statements') should be disclosed.



Following information is also required to be disclosed in the consolidated financial statements separately for the parent and each of its components (including foreign component) which has been consolidated:

(i) amount of net assets and net assets as a percentage of consolidated net assets;

(ii) amount of share in profit or loss and the percentage share in profit or loss as a percentage of consolidated profit or loss;

(iii) amount in other comprehensive income (OCI) and the percentage of OCI as a percentage of Consolidated OCI.[6]

As regards consolidation adjustments (including elimination of intra group transactions), it should be ensured that these are either disclosed as a single line item separately or adjusted in the information (e.g. net assets) disclosed for the parent and its each component.

The Ind AS 110 does not give a list of information which is part of the separate financial statement of the components but that need not be reported in the notes and other explanatory material of the consolidated financial statements, however, based on section 129(4) and MCA circular 39/2014 as referred above, it can be construed that, even in consolidated financial statements under Ind AS, only those disclosures should be given which are relevant to consolidated financial statements.

Based on the above discussion, in case of companies, the information such as the following given in the notes to the separate financial statements of the parent and/or the subsidiary, need not be included in the consolidated financial statements.

(i) Source from which bonus shares are issued, e.g., capitalisation of profits or reserves or from securities premium account.

(ii) Disclosure of all unutilised monies out of the issue indicating the form in which such unutilised funds have been invested.

(iii) Disclosure required under Micro, Small and Medium Enterprises Development Act, 2006.

[6] *For companies which are covered by Ind AS.*

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(iv) A statement of investments (whether shown under "financial assets or non-financial assets as stock-in-trade) separately classifying trade investments and other investments, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate.

(v) Value of imports calculated on C.I.F. basis by the company during the financial year in respect of:

(a) raw materials;

(b) components and spare parts;

(c) capital goods.

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

(vii) Value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption.

(viii) The amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and the year to which the dividends related.

(ix) Earnings in foreign exchange classified under the following heads, namely:

(a) export of goods calculated on F.O.B. basis;

(b) royalty, know-how, professional and consultation fees;

(c) interest and dividend;

(d) other income, indicating the nature thereof.

However, notwithstanding the above, the auditor needs to ensure compliance with disclosure requirements of applicable accounting standards and other applicable laws for consolidated financial statements.

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7. MANAGEMENT REPRESENTATIONS

SA 580, "Written Representations" requires the auditor to obtain written representations from management and, where appropriate, those charged with governance. The auditor of the consolidated financial statements should obtain evidence that the management of the parent acknowledges its responsibility for a true and fair presentation of the consolidated financial statements in accordance with the financial reporting framework applicable to the parent and that parent management has approved the consolidated financial statements. In addition, the auditor of the consolidated financial statements obtains written representations from parent management on matters material to the consolidated financial statements.

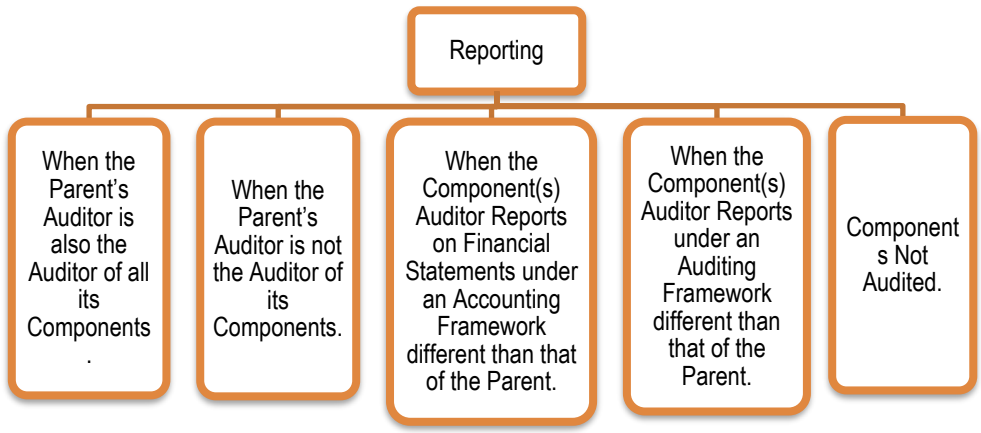
Examples of such representations include

(a) Completeness of components included in the CFS;	(b) Identification of reportable segments for segmental reporting;	(c) Identification of related parties and related party transactions for reporting;	(d) Appropriateness and completeness of permanent and current period consolidation adjustments, including the elimination of intra-group transactions.

8. REPORTING

There could be two situations in an audit of consolidated financial statements—when the parent's auditor is also the auditor of all the components to be included in the consolidated financial statements and when the parent's auditor is not the auditor of one or more components and therefore, uses the work of other auditors in the audit. The auditor should, while preparing the report, consider the requirements of Standard on Auditing (SA) 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report. Where, the auditor uses the work of other auditors in the audit of consolidated financial statements, the requirements of SA 600, "Using the Work of Another Auditor" should also be considered.

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8.1 When the Parent's Auditor is also the Auditor of all its Components

- While drafting the audit report, the auditor should report whether principles and procedures for preparation and presentation of consolidated financial statements as laid down in the relevant accounting standards have been followed.

  In case of any departure or deviation, the auditor should consider the requirements given in SA 705, Modifications to the Opinion in the Independent Auditor's reports in the audit report so that users of the consolidated financial statements are aware of such deviation.

- Auditor should issue an audit report expressing an opinion whether the consolidated financial statements give a true and fair view of the state of affairs of the Group as on balance sheet date and as to whether consolidated profit and loss statement gives true and fair view of the results of consolidated profit or losses of the Group for the period under audit.

- Where the consolidated financial statements also include a cash flow statement, the auditor should also give his opinion on the true and fair view of the cash flows presented by the consolidated cash flow statements.

8.2 When the Parent's Auditor is not the Auditor of all its Components

- In a case where the parent's auditor is not the auditor of all the components included in the consolidated financial statements, the auditor of the consolidated financial statements should also consider the requirement of SA 600.

- As prescribed in SA 706, if the auditor considers it necessary to make reference to the audit of the other auditors, the auditor's report on the consolidated financial statements should

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disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s).

This may be done by stating aggregate rupee amounts or percentages of total assets, revenues and cash flows of components included in the consolidated financial statements not audited by the parent's auditor.

Total assets, revenues and cash flows not audited by the parent's auditor should be presented before giving effect to permanent and current period consolidation adjustments.

Reference in the report of the auditor on the consolidated financial statements to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors of the parent and its subsidiaries.

8.3 When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent

The parent may have components located in multiple geographies outside India applying an accounting framework (GAAP) that is different than that of the parent in preparing its financial statements. Foreign components prepare financial statements under different financial reporting frameworks, which may be a well-known framework (such as US GAAP or IFRS) or the local GAAP of the jurisdiction of the component. Local component auditors may be unable to report on financial statements prepared using the parent's GAAP because of their unfamiliarity with such GAAP.

When a component's financial statements are prepared under an accounting framework that is different than that of the framework used by the parent in preparing group's consolidated financial statements, the parent's management perform a conversion of the components' audited financial statements from the framework used by the component to the framework under which the consolidated financial statements are prepared. The conversion adjustments are audited by the principal auditor to ensure that the financial information of the component(s) is suitable and appropriate for the purposes of consolidation.

A component may alternatively prepare financial statements on the basis of the parent's accounting policies, as outlined in the group accounting manual, to facilitate the preparation of the group's consolidated financial statements. The group accounting manual would normally contain all accounting policies, including relevant disclosure requirements, which are consistent with the requirements of the financial reporting framework under which the group's consolidated financial statements are prepared. The local component auditor can then audit and issue an audit report on the components financial statements prepared in accordance with "group accounting policies".

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When applying the approach of using group accounting policies as the financial accounting framework for components to report under, the principal/parent auditors should perform procedures necessary to determine compliance of the group accounting policies with the GAAP applicable to the parent's financial statements. This ensures that the information prepared under the requirements of the group accounting policies will be directly usable and relevant for the preparation of consolidated financial statements by the parent entity, eliminating the need for auditing by the auditor, the differences between the basis used for the component's financial statements and that of the consolidated financial statements. The principal auditor can then decide whether or not to rely on the components' audit report and make reference to it in the auditor's report on the consolidated financial statements.

8.4 When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent

Normally, audits of financial statements, including consolidated financial statements, are performed under auditing standards generally accepted in India ("Indian GAAS").

In order to maintain consistency of the auditing framework and to enable the parent auditor to rely and refer to the other auditor's audit report in their audit report on the consolidated financial statements, the components' financial statements should also be audited under a framework that corresponds to Indian GAAS.

8.5 Components Not Audited

Generally, the financial statements of all components included in consolidated financial statements should be audited or subjected to audit procedures in the context of a multi-location group audit. Such audits and audit procedures can be performed by the auditor reporting on the consolidated financial statements or by the components' auditor.

Where the financial statements of one or more components continue to remain unaudited, the auditor reporting on the consolidated financial statements should consider unaudited components in evaluating a possible modification to his report on the consolidated financial statements. The evaluation is necessary because the auditor (or other auditors, as the case may be) has not been able to obtain sufficient appropriate audit evidence in relation to such consolidated amounts/balances. In such cases, the auditor should evaluate both qualitative and quantitative factors on the possible effect of such amounts remaining unaudited when reporting on the consolidated financial statements using the guidance provided in SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

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TEST YOUR UNDERSTANDING 2

CA. Kajal is nearing completion of the audit of consolidated financial statements of Rubic Paints and Chemicals Limited. She requires written representations from the parent's management on matters material to the consolidated financial statements. What specific matters can such written representations include?

TEST YOUR UNDERSTANDING 3

CA.M is auditor of consolidated financial statements of "D and D Limited" for year 2023-24. The consolidated financial statements consist of financial statements and financial information of 8 subsidiaries audited by other auditors. Such financial statements, financial information and auditor's reports of subsidiaries have been furnished by management of the "D and D Limited" to him. Following further information is also available in respect of these 8 subsidiaries for year 2023-24: -

Total assets	₹ 1500 crore
Total revenues	₹ 1000 crore
Net cash outflows	₹ 10 crore

Two of these subsidiaries are located outside India whose financial statements have been prepared in accordance with accounting principles generally accepted in their respective countries and which have been audited by other auditors under generally accepted auditing standards applicable in their respective countries.

Where and how should such information be included in the independent auditor's report on consolidated financial statements of company? Also draft a suitable para by making necessary assumptions.

Key Takeaways

- Whenever a parent decides to or is required to prepare and present consolidated financial statements, it should do so in accordance with the requirements of applicable Accounting Standards under the relevant financial reporting framework.
- Accounting Standard (AS) 21, 'Consolidated Financial Statements' and Indian Accounting Standard (Ind AS) 110, 'Consolidated Financial Statements lay down principles and procedures for preparation and presentation of consolidated financial statements under AS and Ind AS respectively.

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- Consolidated financial statements are presented, to the extent possible, in the same format as adopted by the parent for its separate financial statements.
- According to Section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, including associate company and joint venture, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own.
- Section 129(4) of the said Act provides that the provisions applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, also apply to its the consolidated financial statements.
- The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent.
- The principal auditor of the consolidated financial statements is responsible for expressing an opinion on whether the consolidated financial statements are prepared, in all material respects in accordance with the financial reporting framework under which the parent prepares the consolidated financial statements in addition to reporting on the additional matters as required under the Companies Act, 2013 and any other statute to the extent applicable.
- Standards on Auditing, Statements and Guidance Notes on auditing matters issued by the Institute of Chartered Accountants of India (ICAI) apply in the same manner to audit of consolidated financial statements as they apply to audit of standalone financial statements.
- When an auditor accepts the audit of consolidated financial statements, the auditor should assess whether based on his work alone he would be able to express an opinion on the true and fair view presented by the consolidated financial statements. If the auditor is of the view that his own participation may not be enough or sufficient, he should consider using the work of 'Other auditors'.
- Before commencing an audit of consolidated financial statements, the auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner.
- Special considerations like Permanent consolidation adjustments and current period consolidation adjustments need to be taken into account while auditing group financial statements.
- Permanent consolidation adjustments are those adjustments that are made only on the first occasion or subsequent occasions in which there is a change in the shareholding of a

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particular entity which is consolidated. Examples are determination of goodwill or capital reserve, equity attributable to minority shareholders.

- Current period adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done, like elimination of intra-group transactions and account balances.
- There could be two situations in an audit of consolidated financial statements–-when the parent's auditor is also the auditor of all the components to be included in the consolidated financial statements and when the parent's auditor is not the auditor of one or more components and therefore, uses the work of other auditors in the audit.
- The auditor should, while preparing the report, consider the requirements of Standard on Auditing (SA) 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report. Where, the auditor uses the work of other auditors in the audit of consolidated financial statements, the requirements of SA 600, "Using the Work of Another Auditor" should also be considered.
- Where the financial statements of one or more components continue to remain unaudited, the auditor reporting on the consolidated financial statements should consider unaudited components in evaluating a possible modification to his report on the consolidated financial statements. The evaluation is necessary because the auditor (or other auditors, as the case may be) has not been able to obtain sufficient appropriate audit evidence in relation to such consolidated amounts/balances.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Whether preparation of consolidated financial statements is mandatory? If yes, please elaborate on the requirements under the statute.*

2. *Please elaborate on the situations wherein the requirement related to preparation of consolidated financial statements may not apply.*

3. *While doing the audit of Consolidated Financial Statements, which current period consolidation adjustments are to be taken into account?*

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4. *Write a short note on:*

(a) Responsibility of holding company for preparation of Consolidated Financial Statements.

(b) Permanent Consolidated Adjustments.

5. *R Ltd. owns 51% voting power in S Ltd. It however, holds and discloses all the shares as "Stock-in-trade" in its accounts. The shares are held exclusively with a view to their subsequent disposal in the near future. R Ltd. represents that while preparing Consolidated Financial Statements, S Ltd. can be excluded from the consolidation. As a Statutory Auditor, how would you deal?*

6. *A Ltd. holds the ownership of 10% of voting power and control over the composition of Board of Directors of B Ltd. While planning the statutory audit of A Ltd., what factors would be considered by you as the statutory auditors of A Ltd. for the audit of its consolidated financial statements prepared under Ind AS?*

7. *You are appointed as an auditor of Nawab Limited, a listed company who is a main supplier to the UK building and construction market. With a turnover of ₹ 2.9 billion, the company operates through 11 business units and has nearly 180 branches across the countries.*

As an auditor, how will you draft the report in case:

(a) When the Parent's Auditor is also the Auditor of all its Components?

(b) When the Parent's Auditor is not the Auditor of all its Components?

(c) When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent?

(d) When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent?

(e) Where the financial statements of one or more components not audited?

8. *M Ltd. acquired 51 % shares of S Ltd. on 01-04-2023 and sold 25% of these shares during the financial year 2023-24. M Ltd. did not prepare Consolidated Financial Statements for the financial year 2023-24 on the plea that the control was only temporary. Do you agree with the view of M Ltd.? Decide, assuming, that M Ltd. is required to prepare its financial statements under Ind AS.*

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9. *H Limited is an Investment Company preparing its Financial Statements in accordance with Ind AS. The Company obtains funds from various investors and commits its performance for fair return and capital appreciation to its investors. During the year under audit, it had been observed that the Company had invested 25% in S1 Ltd., 50% in S2 Ltd. and 60% in S3 Ltd. of the respective share capitals of the Investee Companies. When checking the investment schedule of the Company, an issue cropped as to whether there would arise any need to consolidate accounts of any such investee companies with those of H Limited in accordance with section 129(3) of the Companies Act, 2013 which contains no exclusion from consolidation. Analyse the issues involved and give your views.*

10. *Venus Ltd. is a company engaged in the manufacture of stainless steel items. The company operates through 5 business units and has 35 branches across India. Manglam & Associates are being appointed as the principal auditor of the company. While accepting the audit assignment as the principal auditor, what will be the points of consideration for the principal auditor of the company?*

11. ***R Limited is a listed company engaged in manufacture of round bars. The company is having investment in the following components:***

(i) 2 Subsidiary Companies

(ii) 1 Joint Venture Company

(iii) 2 Associate Companies

(iv) 3 Business entities under common control

(v) Interest in assets, liabilities, revenues, and expenses in a joint operation with 1 Company

R Limited and all its components are required to present their accounts as per Ind AS. While preparing consolidated financial statements, R Limited consolidated its components on a line-by-line basis by adding together like items of assets, liabilities, income, expenses, and cash flows.

R Limited seeks your advice on the accounting treatment in respect of the above components for consolidation in accordance with the Companies (Indian Accounting Standards) Rules, 2015.

12. ***CA H was appointed as a Statutory Auditor of MNL Limited, a listed company, which has three subsidiaries namely M Ltd., N Ltd., L Ltd. and also 15 branches across India.***

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The Auditors are duly appointed for all the subsidiaries and branches. What should be the considerations of CA H regarding determination of materiality during the audit of consolidated financial statements? How he should deal in his report if there are observations (for instance modification and/or emphasis of matter paragraph in accordance with SA 705/706) made by component auditors?

Answers to Test your Understanding

1. The auditor should verify that all the components have been included in the consolidated financial statements unless these components meet criterion for exclusion. In respect of completeness of this information, the auditor should perform the following procedures:

(a) review his working papers for the prior years for the known components

(b) review the parent's procedures for identification of various components

(c) make inquiries of management to identify any new components or any component which goes out of consolidated financial statements

(d) review the investments of parent as well as its components to determine the shareholding in other entities

(e) review the joint ventures and joint arrangements as applicable

(f) review the other arrangements entered into by the parent that have not been included in the consolidated financial statements of the group

(g) review the statutory records maintained by the parent, for example registers under section 186, 190 of the Companies Act, 2013

(h) also identify the changes in the shareholding that might have taken place during the reporting period.

2. The auditor of the consolidated financial statements should obtain written representations from parent's management on matters material to the consolidated financial statements. Examples of such representations include:

(a) Completeness of components included in the consolidated financial statements;

(b) Identification of reportable segments for segment reporting

(c) Identification of related parties and related party transactions for reporting

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(d) Appropriateness and completeness of permanent and current period consolidation adjustments, including the elimination of intra-group transactions.

3. In a case where the parent's auditor is not the auditor of all the components included in the consolidated financial statements, then as prescribed in SA 706, if the auditor considers it necessary to make reference to the audit of the other auditors, the auditor's report on the consolidated financial statements should disclose clearly the magnitude of the portion of the financial statements audited by the other auditors. This may be done by stating aggregate rupee amounts or percentages of total assets, revenues and cash flows of components included in the consolidated financial statements not audited by the parent's auditor.

It should be included in Other Matter paragraph of independent auditor's report. The draft "Other Matter Paragraph" is as under: -

Other Matter Paragraph

We did not audit the financial statements and other financial information, in respect of eight (8) subsidiaries, whose financial statements include total assets of Rs.1500 crores as at March 31, 2023, and total revenues of Rs.1,000 crores and net cash outflow of Rs. 10 crores for the year ended on that date. These financial statements and other financial information have been audited by other auditors and such financial statements, other financial information and auditor's reports have been furnished to us by the management of the Holding Company.

Our opinion on the consolidated financial statements, in so far as it relates to the amounts and disclosures included in respect of these subsidiaries and joint ventures, and our report in terms of sub-sections (3) of Section 143 of the Act, in so far as it relates to the aforesaid subsidiaries is based solely on the reports of such other auditors.

Two of these subsidiaries are located outside India whose financial statements and other financial information have been prepared in accordance with accounting principles generally accepted in their respective countries and which have been audited by other auditors under generally accepted auditing standards applicable in their respective countries. The Holding Company's management has converted the financial statements of such subsidiaries from accounting principles generally accepted in their respective countries to accounting principles generally accepted in India.

We have audited these conversion adjustments made by the Holding Company's management. Our opinion in so far as it relates to the balances and affairs of such subsidiaries is based on the report of other auditors and the conversion adjustments prepared by the management of the Holding Company and audited by us. Our opinion on the

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consolidated financial statements, and our report on Other Legal and Regulatory Requirements is not modified in respect of the above matters with respect to our reliance on the work done and the reports of the other auditors and the financial statements and other financial information certified by the Management.

Answers to Theoretical Questions

1. Refer Para 1.1

2. The requirement related to preparation of consolidated financial statements shall not apply to a company if it meets the following conditions:

(i) it is a wholly-owned subsidiary, or is a partially-owned subsidiary of another company and all its other members, including those not otherwise entitled to vote, having been intimated in writing and for which the proof of delivery of such intimation is available with the company, do not object to the company not presenting consolidated financial statements;

(ii) it is a company whose securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; and

(iii) its ultimate or any intermediate holding company files consolidated financial statements with the Registrar which are in compliance with the applicable Accounting Standards.

3. Refer Para 6.2

4. (a) Refer Para 2

(b) Refer Para 6.1

5. **Consolidation of Financial Statement:** As per Ind AS 110, there is no such exemption for 'temporary control', or "for operation under severe long-term funds transfer restrictions" and consolidation is mandatory for Ind AS compliant financial statement in this case. Paragraph 20 of Ind AS 110 states that "Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee".

However, as per Section 129(3) of the Companies Act, 2013 read with rule 6 of the Companies (Accounts) Rules, 2014, where a company having subsidiary, which is not required to prepare consolidated financial statements under the Accounting standards, it shall

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be sufficient if the company complies with the provisions on consolidated financial statements provided in Schedule III to the Act.

In the given case, R Ltd's intention is to dispose off the shares in the near future as shares are being held as stock in trade and it is quite clear that the control is temporary, Therefore, R Ltd. is required to prepare Consolidated Financial Statements in accordance with Ind AS 110 as exemption for 'temporary control' is not available under Ind AS 110.

6. **10% Voting Power and Control over the composition of Board of Directors:** In this case, A Ltd. holds only 10 percent of the voting power but has control over the composition of the Board of Directors of B Ltd.

In such a case, A Ltd. shall be considered as a parent of B Ltd and, therefore, it would consolidate B Ltd. in its consolidated financial statements as a subsidiary.

The auditor should verify A Ltd.'s management's assessment of having control in B Ltd. despite having only 10% voting power as per the requirements of Ind AS 110. Auditor would need to verify as to how A Ltd. controls the composition of the Board of Directors or corresponding governing body of B Ltd.

There can be various means by which such kind of control can be established. In this regard, the auditor may verify the minutes of Board meetings, shareholder agreement entered into by the parent, agreements with B Ltd. to which the parent might have provided any technology or know how, enforcement of statute, etc.

Further, the auditor should verify that the adjustments warranted by Ind AS 110 have been made wherever required and have been properly authorised by the management of the parent. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period consolidation adjustments. The auditor should make plan, among other things, for the understanding of accounting policies of the A Ltd. and B Ltd. and determining and programming the nature, timing, and extent of the audit procedures to be performed etc.

Further, the duties of an auditor with regard to reporting of transactions with any other related parties are given in SA 550 on Related Parties. As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity are considered as Related Party.

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In forming an opinion on the financial statements, the auditor shall evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with Ind AS 110 and Schedule III and whether the effects of the related party relationships and transactions prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks) or cause the financial statements to be misleading (for compliance frameworks).

7. Refer Para 8

8. **Consolidation of Financial Statement:** As per Ind AS 110, there is no such exemption for 'temporary control', or "for operating under severe long-term funds transfer restrictions" and consolidation is mandatory for Ind AS compliant financial statement in this case.

Ind AS 110 states that "Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee".

In the given case, M Ltd. acquired 51% shares of S Ltd. on 01.04.2023 and sold 25% shares during the year ended 2023-24. M Ltd. did not consolidate the financial statements of S Ltd. for the year ended 31.03.2024 on the plea that control was only temporary. The intention of M Ltd. is quite clear that the control in S Ltd. is temporary as the former company disposed off the acquired shares in the same year of its purchase.

However, even though the intention of M Ltd. is for temporary holding of shares in S Ltd. as per Ind AS, M Ltd. is required to prepare Consolidated Financial Statements in accordance with Ind AS 110 as exemption for 'temporary control' is not available under Ind AS 110. However, "Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee". Here, due to sale of investment in S Ltd. up to 25%, M Ltd. loses control of S Ltd.

Accordingly, M Ltd. is required to prepare a consolidated statement till the date of disposal of the 25% shares to comply with the same.

9. **Consolidated Financial Statements:** According to Section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, including associate company and joint venture, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own.

Further, as per Companies (Accounts) Rules, 2014, the consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III to the Act

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and the applicable accounting standards. However, a company which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

However, an investment entity need not present consolidated financial statements if it is required, in accordance with Ind AS 110'Consolidated Financial Statements', to measure all of its subsidiaries at fair value through profit or loss. A parent shall determine whether it is an investment entity.

(An investment entity is an entity that(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; (b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and (c) measures and evaluates the performance of substantially all of its investments on a fair value basis.)

In the given case, H Limited is an investment company preparing its financial statements in accordance with Ind AS and the company had invested 25% in S1 Ltd., 50% in S2 Ltd. and 60% in S3 Ltd. of the respective share capitals of the investee companies. In view of provisions discussed in Ind AS 110, the Company is not required to prepare consolidated financial statements however, for the compliance of Companies (Accounts) Rules, 2014, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

Thus, it can be concluded that ultimate authority on consolidation is AS / Ind AS as prescribed by law and if they give some exemption it should be followed. If out of exemption some subsidiaries are not consolidated, then list should be disclosed in notes to accounts with reason.

10. Acceptance as Principal Auditor : The principal auditor, Manglam & Assocaites, should consider whether their own participation is sufficient to be able to act as the principal auditor. For this purpose, the auditor would consider:

(a) the materiality of the portion of the financial information which the principal auditor audits;

(b) the principal auditor's degree of knowledge regarding the business of the components;

(c) the risk of material misstatements in the financial information of the components audited by the other auditor; and

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(d) the performance of additional procedures as set out in this SA regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

11. Refer Para 5 point (b) in table

In the given situation, R Limited is, a listed company having investment in the (i) 2 Subsidiary Companies, (ii) 1 Joint Venture Company, (iii) 2 Associate Companies, (iv) 3 Business entities under common control, (v) Interest in assets, liabilities, revenues, and expenses in a joint operation with 1 Company. R Limited and all its components are required to present their accounts as per Ind AS. In view of above, R Limited consolidated its components on a line-by-line basis by adding together like items of assets, liabilities, income, expenses, and cash flows while preparing its consolidated financial statements which is correct for the subsidiaries, however the treatment is not correct for other components as per abovementioned Companies (Indian Accounting Standards) Rules, 2015.

12. CA H should consider the requirement of SA 600, "Using the Work of Another Auditor", if he decides to use the work of another auditor in relation to the audit of consolidated financial statements and he should comply with the requirements of SA 600.

In carrying out the audit of the standalone financial statements, the computation of materiality for the purpose of issuing an opinion on the standalone financial statements of each component would be done component-wise on a standalone basis.

However, with regard to determination of materiality during the audit of consolidated financial statements (CFS), the auditor should consider the following:

(i) The auditor is required to compute the materiality for the group as a whole. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e. permanent consolidation adjustments and current period consolidation adjustments) that are made by the management in the preparation of CFS.

(ii) The parent auditor can also use the materiality computed on the group level to determine whether the component's financial statements are material to the group to determine whether they should scope in additional components, and consider using the work of other auditors as applicable.

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(iii) The principal auditor also computes materiality for each component and communicates to the component auditor, if he believes is required for true and fair view on CFS.

(iv) The principal auditor also obtains certain confirmations from component auditors like independence, code of ethics, certain information required for consolidation and disclosure requirements etc.

However, while considering the observations (for instance modification and /or emphasis of matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the principles of SA 600 need to be considered i.e. CA H (the parent auditor) should comply with the requirements of SA 600, "Using the Work of Another Auditor".

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CHAPTER 14

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES



UNIT 1 – SPECIAL FEATURES OF AUDIT OF BANKS

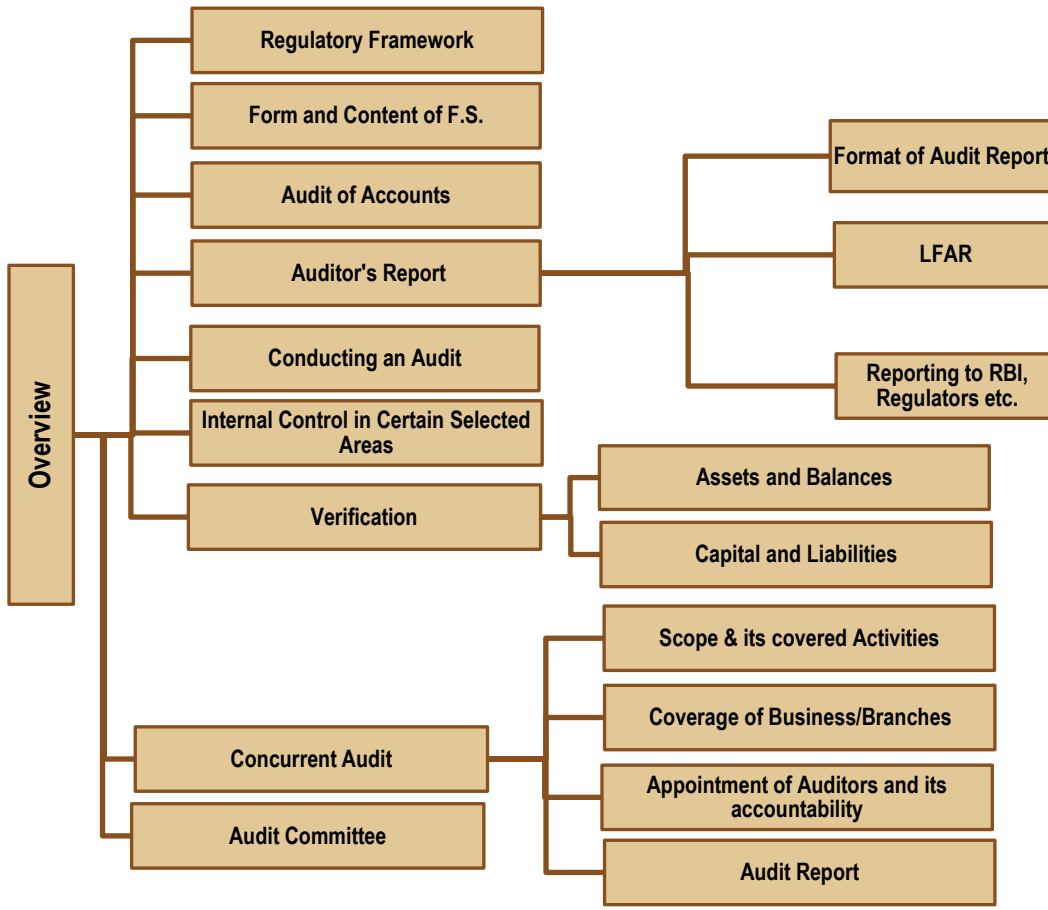
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Gain the knowledge of legal framework, form and content of financial statements of the banks.
- Know the features of audit of accounts and auditor's report.
- Understand CRR, SLR and Capital Adequacy etc.
- Understand the prescribed procedure to be followed while doing verification of assets and liabilities of the bank.
- Acquire the knowledge of Concurrent Audit and types of activities to be covered in it.
- Know the role of audit committee in audit of banks.

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UNIT OVERVIEW



Viraj & Associates, an auditing firm of long standing and experience, has been appointed as one of Statutory Central Auditors of a nationalized bank. Trying to gain understanding of the working of the bank including its internal control along with joint auditors, CA Mansukh is also involved in reviewing treasury operations of the bank as part of gaining insight into the bank's working.

Why are treasury operations of a bank significant from point of view of an auditor? Treasury operations are responsible for processing all financial market transactions and play a crucial role in managing risks. Investments and forex & derivatives form two main components of

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treasury. In view of regulatory prudential norms on investments, audit of investments becomes very important as non-compliance with regulations could have a direct and material effect on financial statements of the bank. He is also trying to gain understanding of General IT controls and system application controls relating to these as investment function is automated in Bank.

He is also gaining knowledge of various types of deposit products of the bank (like CASA and term deposits) and process of determination of interest rates and other charges of these deposits as per rules laid down by bank. Going through bank policy on customer acceptance, procedures to verify compliance of KYC norms are in the offing. Apart from it, planned verification of application of rate of interest to every deposit product on sample basis is also on the table. Verification of movement of interest expenses is also in audit plan arsenal.

He is also going through complaints lodged by bank customers. What is the necessity to plan procedures in this respect? Does the auditor of a bank have anything to do with customer complaints? Certainly. It is due to the fact that such complaints may result into material liability or contingent liability.

CA Piyush, Partner of P K S D & Associates (joint auditor) is in the process of familiarising himself with the credit recovery policy of the Bank and guidelines of RBI regarding accounting and income recognition in this respect. He is also considering the extent of automation of process relating to accounting of recovery of credit portfolio of the Bank. Besides, he wants to ensure consistency in income recognition process relating to order of recovery and its synchronization with internal policy of the Bank. He is also planning procedures to ensure the upgradation of NPAs during the year in accordance with RBI norms.

Review of activities of credit monitoring and restructuring department of Bank also falls in domain of his responsibilities. Why is such a review important for him as an auditor? It is due to the reason this department is responsible for implementing Bank's policies relating to credit monitoring and restructuring. Credit monitoring policy helps in managing credit risks in a systematic and effective manner. Further, this department may also be responsible for sanctioning of restructuring of stressed advances in accordance with RBI guidelines.

CA Gopal, Partner of GSK & Co. (joint auditor) is verifying internal/office accounts of the bank including sundry/suspense accounts. Why does such verification assume importance? Such accounts can be used to commit fraud and malpractices like unauthorized opening and operation of such accounts for affording credits to certain borrower accounts to prevent them from slipping into NPAs. Opening of such accounts as well as their periodic reconciliation becomes too significant for Statutory Central Auditors to ignore.

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1. INTRODUCTION

The banking industry is the pivot of any economy and its financial system. Banks are one of the foremost agents of financial intermediation in an economy like India and, therefore, development of a strong and resilient banking system is of utmost importance. The banking institutions in the country are working in a competitive environment and their regulatory framework is aligned with the international best practices. Thus, financial deepening has taken place in India and continues to be in progress with a focus on orderly conditions in financial markets while sustaining the growth momentum.



Banks have certain characteristics distinguishing them from most other commercial enterprises.

- Custody of large volumes of monetary items, including cash and negotiable instruments, whose physical security has to be ensured. This applies to storage and the transfer of monetary items, making banks vulnerable to misappropriation and fraud, necessitating establishment of formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.
- Engagement in a large volume and variety of transactions in terms of number and value which necessarily require complex accounting and internal control systems and widespread use of Information Technology (IT).
- Operation through a wide network of geographically dispersed branches and departments necessitating a greater decentralization of authority and dispersal of accounting and control functions, with consequent difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
- Assumption of significant commitments without any transfer of funds. These items, called 'off-balance sheet' items, may at times not involve accounting entries and the failure to record such items may be difficult to detect.
- Engagement in transactions that are initiated at one location, recorded at a different location and managed at yet another location.
- Direct Initiation and completion of transactions by the customer without any intervention by the bank's employees. **For example,** over the Internet or mobile or through automatic teller machines (ATMs).

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- Integration and linkages of national and international settlement systems could pose a systemic risk to the countries in which they operate.
- Regulatory requirements by governmental authorities often influence accounting and auditing practices in the banking sector.

Special audit considerations arise in the audit of banks because of:



- the particular nature of risks associated with the transactions undertaken;
- the scale of banking operations and the resultant significant exposures which can arise within short period of time;
- the extensive dependence on IT to process transactions;
- the effect of the statutory and regulatory requirements;
- the continuing development of new products and services and banking practices which may not be matched by the concurrent development of accounting principles and auditing practices.

Evolution of technology and providing services through Net Banking and Mobiles has exposed banks to huge operational and financial risk.

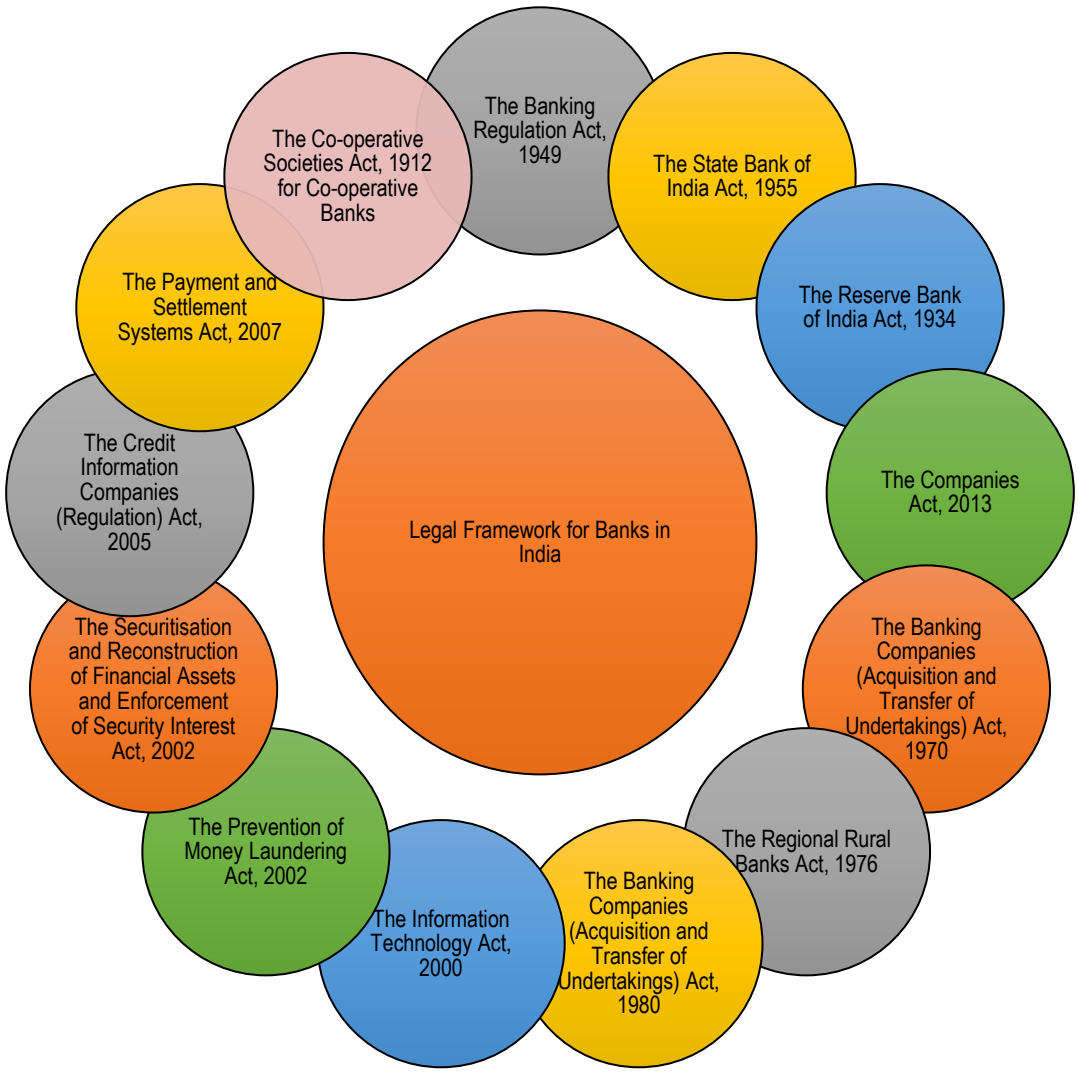
The auditor should consider the effect of the above factors in designing his audit approach. It is imperative for Branch Auditors and SCAs (Statutory Central Auditors) to have detailed knowledge of the products offered and risks associated with them, and appropriately address them in their audit plan to the extent they give rise to the risk of material misstatements in the financial statements.

In today's environment, the banks use different applications to carry out different transactions which may include data flow from one application to other application; the auditor while designing his plans should also understand interface controls between the various applications.

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2. LEGAL FRAMEWORK

There is an elaborate legal framework governing the functioning of banks in India. The principal enactments which govern the functioning of several types of banks are:



Further, the Reserve Bank of India Act, 1934 gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

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3. FORM AND CONTENT OF FINANCIAL STATEMENTS

Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

Every banking company needs to comply with the disclosure requirements under the various Accounting Standards, as specified under section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or the Accounting Standards issued by the ICAI. It may be noted that implementation of Indian Accounting Standards (Ind AS) has been deferred by RBI for all scheduled commercial banks presently.

It is pertinent to state that preparation of balance sheet of a bank usually involves preparation of standalone financial statements and consolidated financial statements. Preparation of Standalone financial statements involve consolidation of branch accounts and incorporation of various verticals/departments of bank in case of a nationalized bank/public sector bank. The detailed procedures in this regard may vary from bank to bank. In case of private banks, the processes of accounting are centralized and there is no concept of mandatory branch audit in accordance with RBI guidelines.

Public sector banks and private banks are listed on recognized stock exchange and are required to comply with SEBI regulations including LODR.

3.1 Audit of Accounts & Appointment of Auditor

Sub-section (1) of section 30 of the Banking Regulation Act requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

Most banks, especially those in nationalised banks or public sector, appoint four or more (depending upon their size and Board decision, as per RBI guidelines) firms of chartered accountants to act jointly as statutory central auditors (SCAs).

The appointment letter sent by banks in connection with the appointment of SCAs typically contains the following:

- Period of appointment.

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- Particulars of other central auditors.
- Particulars of previous auditors.
- Procedural requirements to be complied with in accepting the assignment. **Example** 1. Letter of acceptance (the letter usually contains, *inter alia*, averment as to absence of disqualification for appointment, way in which the audit has to be conducted and confirmation of present name, constitution and address of the auditor), declaration of fidelity and secrecy, restriction on accepting other assignments from the bank, etc.
- A statement of division of work and review and reporting responsibilities amongst joint auditors in case of nationalised banks (Generally this is decided at a later stage).
- Scope of assignment which includes any special reports or certificates to be given by the SCAs in addition to the main report.
- In case of statutory branch auditors (SBAs), appointment letter is given on similar lines except in regard to particulars of other auditors and statement of division of work. However, it is to be noted that statutory branch audit is carried out by a single firm of chartered accountants.

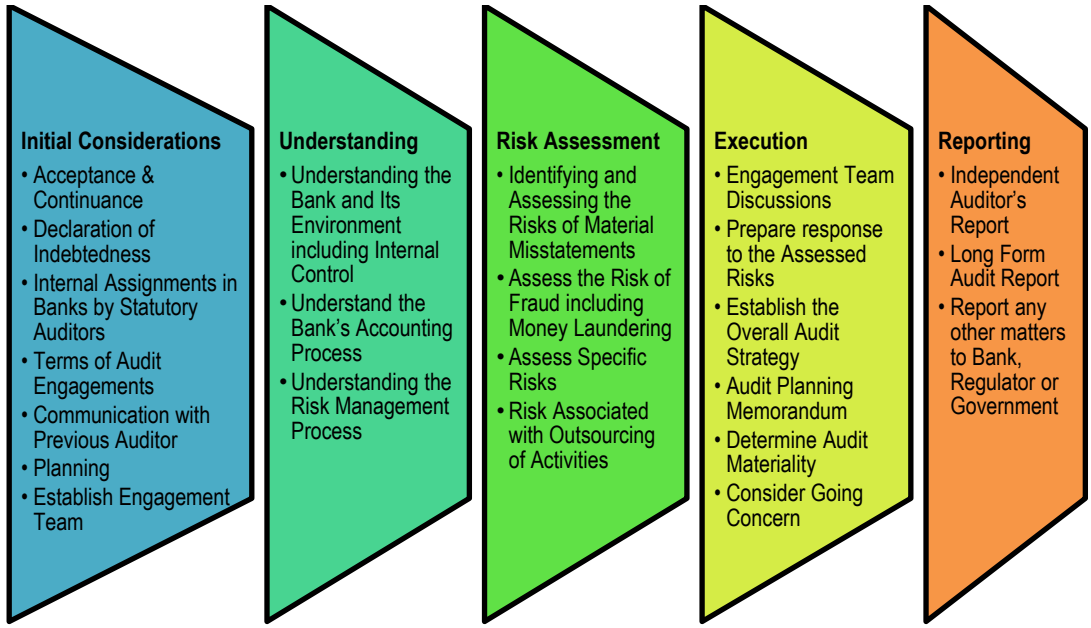
Authority appointing the Auditors - As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the concerned bank acting through its Board of Directors.

In either case, approval of the Reserve Bank is required before the appointment is made.

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4. CONDUCTING AN AUDIT

The audit of banks or of their branches involves the following stages –



Stage I: Initial Considerations

Acceptance & Continuance: The assessment of engagement risk is a critical part of the audit process and should be done prior to the acceptance of an audit engagement since it affects the decision of accepting the engagement and in planning decisions if the audit is accepted.

Declaration of Indebtedness: The RBI has advised that the banks, before appointing their statutory central//branch auditors, should obtain a declaration of indebtedness i.e., a written confirmation that auditor/firm/partners/family members have not been declared as wilful defaulters by any bank/financial institution This is in addition to the declaration regarding absence of disqualifications stipulated in Section 141 of the Companies Act 2013 which includes borrowing above stipulated amount. Students may refer Chapter on Bank Audit of CA Intermediate Auditing and Ethics Study Material.

Internal Assignments in Banks by Statutory Auditors: The RBI decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year.

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Terms of Audit Engagements: SA 210, "Terms of Audit Engagements" requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork. It is imperative that the terms of the engagement are documented, to prevent any confusion as to the terms that have been agreed in relation to the audit and the respective responsibilities of the management and the auditor, at the beginning of an audit relationship. This is usually done in the form of engagement letter which is written by the auditor and acknowledged by the bank.

Communication with Previous Auditor: As per Clause (8) of the Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him/her in writing.

Planning: The audit plan needs to be properly documented with respect to timing, extent of checking, audit procedures to be followed at assertion level and should be flexible and updated or changed, as and when necessary.

Establish the Engagement Team: The assignment of qualified and experienced professionals is an important component of managing engagement risk. The size and composition of the engagement team would depend on the size, nature, and complexity of the bank's operations.

Stage II : Understanding

Understanding the Bank and Its Environment including Internal Control: An understanding of the bank and its environment, including its internal control, enables the auditor:

- to identify and assess risk;
- to develop an audit plan to determine the operating effectiveness of the controls, and to address the specific risks.

Understand the Bank's Accounting Process: The accounting process produces financial and operational information for management's use and it also contributes to the bank's internal control. Thus, understanding of the accounting process is necessary to identify and assess the risks of material misstatement whether due to fraud or not, and to design and perform further audit procedures.

Understanding the Risk Management Process: Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

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Oversight by those charged with governance	*Identification, measurement and monitoring of risks*	*Control activities*	*Monitoring activities*	*Reliable information systems*
• Those charged with governance (BOD/Chief Executive Officer) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.	• Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.	• A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting of limits, reporting and approval of exceptions, physical security and contingency planning.	• Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.	• Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

Stage III : Risk Assessment

Identifying and Assessing the Risks of Material Misstatements: SA 315 requires the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures.

Assess the Risk of Fraud including Money Laundering: As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately. The attitude of professional scepticism should be maintained by the auditor to recognise the possibility of misstatements due to fraud.

The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms. The RBI has from time to time issued guidelines ("Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

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Assess Specific Risks: The auditors should identify and assess specific risks of material misstatement at the financial statement level which refers to risks that relate to the banking industry and the use of IT therein.

Risk Associated with Outsourcing of Activities: The modern-day banks make extensive use of outsourcing as a means of both reducing costs as well as making use of services of an expert not available internally. There are, however, certain risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks.

Stage IV: Execution

Engagement Team Discussions: The engagement team should hold discussions to gain better understanding of bank and its environment, including internal control, and to assess the potential for material misstatements of the financial statements.

Response to the Assessed Risks: SA 330 "The Auditor's Responses to Assessed Risks" requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. The auditor should design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

Establish the Overall Audit Strategy: SA 300 "Planning an Audit of financial Statements'' states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this purpose, the audit engagement partner should:

- establish the overall audit strategy, prior to the commencement of an audit; and
- involve key engagement team members and other appropriate specialists while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.

Audit Planning Memorandum: The auditor should summarise the team's audit plan by preparing an audit planning memorandum in order to:

- Describe the expected scope and extent of the audit procedures to be performed by the auditor.
- Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.
- Provide evidence that they have planned the audit engagement appropriately and have responded to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.

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Determine Audit Materiality: The auditor should consider the relationship between the audit materiality and audit risk when conducting an audit. The determination of audit materiality is a matter of professional judgment and depends upon the knowledge of the bank, assessment of engagement risk, and the reporting requirements for the financial statements. Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or combination of both.

Consider Going Concern: In obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast significant doubt on the bank's ability to continue as a going concern.

Stage V: Reporting

Students should refer to the reporting requirements explained in heading '**Auditor's Report'** of this Chapter.

[**Note:** For detailed understanding of stages involved for conducting an audit, as discussed above, students may refer Guidance Note on Audit of Banks.]

4.1 Special Considerations in IT Environment

The advent of working in CBS environment in banks coupled with changes in technology, use of different payment systems and integration of Aadhar for cardless transactions have changed the way banking used to be in earlier times. However, the technological developments have brought new challenges for auditors as audit is required to be conducted through the system. Considering the importance of IT systems in preparation and presentation of financial statements, it is imperative that bank should share detailed information with auditors like: -

- Overall IT policy, structure and environment of Bank's IT system
- Data processing and data interface under various systems
- Data integrity and data security
- Business Continuity plans and disaster control plans
- Accounting manual and critical accounting entries, their processes and involvement of IT systems
- Controls over key aspects, use of various account heads, expense booking, overdue identification etc.
- Controls on recording of various e-banking and internet banking products and channels
- MIS reports being generated and their periodicity

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- Major exception reports and process of generation including embedded logic
- Process of generating various information related to various disclosures in financial statements and involvement of IT systems

Overall review of IT environment and computerized accounting system has to be taken at head office level. The branch auditors generally do not have access to IT policy and processes implemented by the bank. Hence, based upon guidance and information received from Statutory central auditors, branch auditors need to ensure that data review and analysis through CBS is carried out and tests of controls and substantive checking of sample transactions is carried out at branch level and results are shared with statutory central auditors.

It is responsibility of statutory central auditors to obtain understanding of IT environment and various controls put in place by management and evaluate whether controls are operating effectively. The methodology adopted by the bank in implementing and monitoring controls should be discussed with head of IT department and based on this understanding, audit procedures can be designed. The key security control aspects that an auditor needs to address when undertaking audit in a computerised bank include:

- Ensure that authorised, accurate and complete data is made available for processing.
- Ensure that in case of interruption due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records.
- Ensure that the system prevents unauthorised amendments to the programmes.
- Verify whether "access controls" assigned to the staff-working match with the responsibilities as per manual. It is important for the auditor to ensure that access and authorisation rights given to employees are appropriate.
- Verify that segregation of duties is ensured while granting system access to users and that the user activities are monitored by performing an activities log review.
- Verify that changes made in the parameters or user levels are authenticated.
- Verify that charges calculated manually for accounts when function is not regulated through parameters are properly accounted for and authorised.
- Verify that exceptional transaction reports are being authorised and verified on a daily basis by the concerned officials. It is important for auditor to understand the nature of exception and its impact on financials.
- Verify that the account master and balance cannot be modified/amended/altered except by the authorised personnel.

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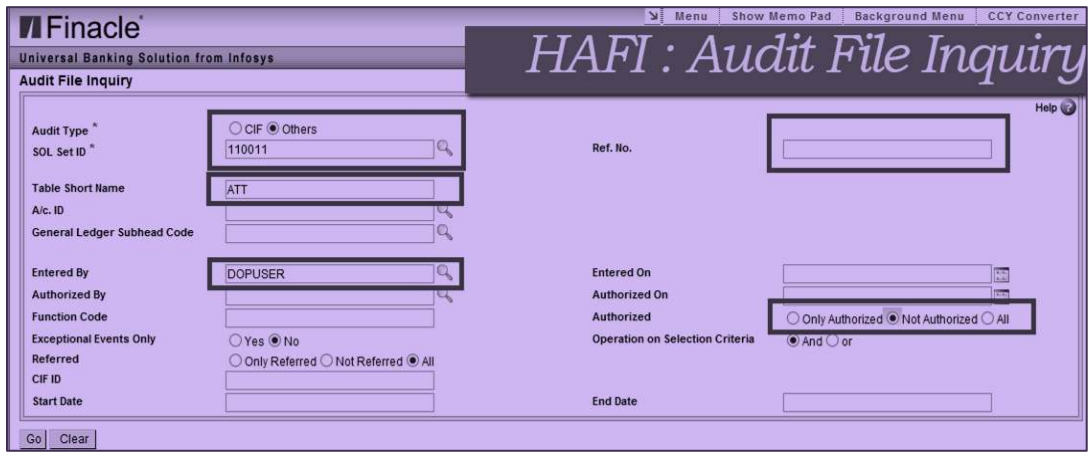
- Verify that all the general ledger accounts codes authorised by Head Office are in existence in the system.
- Verify that balance in general ledger tallies with the balance in subsidiary book. .

4.2 Internal Audit and Inspection

Central audit and inspection department in Banks is a combination of centralized function with some level of decentralization which is usually headed by a Chief Audit Executive. It is responsible for undertaking Risk-Based Internal Audit (RBIA) as per the framework as stipulated by RBI. It is also responsible for identification of branches for revenue audit, appointment of concurrent auditors, deciding their scope, meeting the concurrent auditors, discussing their issues, conducting trainings if needed, and review of work of concurrent auditors. The primary function is to ensure that the audit function is handled smoothly, effectively & efficiently.

Risk-based Internal audit is conducted based upon the risk assessment of business and control risks of branches. The risk assessment process includes: -

- Identification of inherent business risks in various activities undertaken by branches (Business risk)
- Assessment of effectiveness of control systems for monitoring inherent risks of business activities of branch (Control risk)
- Making an assessment of level and direction of various risk areas and assess level and direction of overall business risk and control risk
- Drawing up of risk matrix taking into account factors viz. Risk of branch



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5. INTERNAL CONTROL IN CERTAIN SELECTED AREAS

System of Internal Control in Banks: Banks are required to implement and maintain a system of internal controls for mitigating risks, maintaining good governance and to meet the regulatory requirements. Given below are examples of internal controls that are typically implemented in a bank:

Area of Focus	Examples of Internal Controls in a Bank
General	• The staff and officers of a bank should be shifted from one position to another frequently and without prior notice. • The work of one person should always be checked by another person (usually by an officer) in the normal course of business. • The arithmetical accuracy of the books should be proved independently every day. • All bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.) should be kept in the possession of an officer, and another responsible officer should verify the issuance and stock of such stationery. • The mail should be opened by a responsible officer. Signatures on all the letters and advices received from other branches of the bank or its correspondence should be checked by an officer with the signature book. • The signature book and the telegraphic code book should be kept with responsible officers and access should be allowed only to authorised officers. • The bank should take out insurance policies against loss due to all the risks such as fire, natural calamities, theft and employees' infidelity. • The financial powers of officers of different grades should be clearly defined. • There should be surprise inspection of head office and branches at periodic intervals by the internal audit department. The irregularities pointed out in the inspection reports should be promptly rectified.
Cash	• Cash should be kept in the joint custody of two responsible officers. • In addition to normal checking by the chief cashier, cash should be test-checked daily and counted in full occasionally by a responsible

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	officer other than those handling the cash. Actual cash in hand should agree with the balance shown by the Day Book every day. • The cashier should have no access to the customer's ledger accounts and the Day Book. This is an important safeguard as the Bank managements are often tempted to use cashiers because of their shorter working hours as ledger clerks in the absence of regular staff etc. This can result in substantial losses to the bank. • The counterfoil of cash receipt vouchers (e.g. counterfeits of pay-in-slips lodged by the depositors) should be signed by an officer in Cash Department, in addition to the receiving cashier. • Payments should be made only after the vouchers (e.g. cheques, demand drafts etc.) have been passed for payment by the authorised officer and have been entered in the customer's account. • Receipt and payment scrolls, or their totals should be compared with the cash column of the Day-Book by independent persons. • High value cash receipts and payments should be verified by a higher officer/ branch manager and the excess cash balance should be remitted to the currency chest according to branch's retention limit on daily basis.
Clearings	• Under the Cheque Truncation System (CTS) implemented by RBI, an electronic image of the cheque is transmitted to the paying branch through the clearing house, along with relevant information like data on the MICR band, date of presentation, presenting bank, etc. This effectively eliminates the associated cost of movement of the physical cheques, and reduces the time required for their collection. • As per RBI guidelines, the branch is required to either call the customer or email him for any cheque received for the amount of ₹ 5 lakh and above in respect of inward clearings. The Auditor may verify the compliance on test check basis. • The Auditor is required to check whether the signature of the drawer of the cheque is being verified by the staff or not as else there will be liability of the paying bank under all circumstances. • The unpaid cheques received in outward clearing should be either sent to the customers at their recorded address or the customers be informed to collect the same from bank branch.
Bills for Collection	• All the documents accompanying the bills should be received and entered in the Register by a responsible officer. At the time of dispatch,

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	the officer should also see that all the documents are sent along with the bills. • The accounts of customers or principals should be credited only after the bills have been collected or an advice to that effect received from the bank branch or agent to which they were sent for collection. • It should be ensured that bills sent by one branch for collection to another branch of the bank are not taken in the bills for collection twice in the amalgamated balance sheet of the bank. For this purpose, the receiving branch should reverse the entries regarding such bills at the end of the year for closing purposes.
Bills Purchased	• At the time of purchase of the bills, an officer should verify that all the documents of title are properly assigned to the bank. • Sufficient margin should be kept while purchasing or discounting a bill to cover any decline in the value of the security etc. • If the bank is unable to collect a bill on the due date, immediate steps should be taken to recover the amount from the drawer against the security provided. • All irregular outstanding account/s should be reported to the Head Office. • In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years.
Loans and Advances	• The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank. • All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made. • Sufficient margin should be kept against securities taken to cover any decline in the value thereof and to comply with Reserve Bank directives. Such margins should be determined by the proper authorities of the bank as a general policy or after detailed scrutiny for specific accounts. • All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers. • All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give the title of the bank.

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	• All accounts should be kept within both the drawing power and the sanctioned limit as per prescribed norms. Additional temporary limit may be sanctioned, for a maximum of 20% of existing limit and 90 days maximum tenure. • All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly. • The operation (in each advance account) should be reviewed at least once every year.)
Demand Drafts	• The signatures on a demand draft should be checked by an officer with the Signature Book. • All the D.Ds. sold/ issued by a branch should be immediately confirmed by an advice to the paying branch. • If the paying branch does not receive proper confirmation of any D.D. from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to ascertain the reasons.
Inter Branch Accounts	• The accounts should be adjusted only on the basis of advice (and not on the strength of entries found in the statement of account) received from other branches, • Prompt action should be taken, preferably by central authority, if any entries (particularly debit entries) are not responded to by any branch within a reasonable time.
Credit Card Operations	• There should be effective screening of applications with reasonably good credit assessments. • There should be strict control over storage and issue of cards. • There should be a system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement, in case the amount to be settled exceeds a specified percentage of the total limit of the card holder. • There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards. • Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards. • All the reimbursement (gross of commission) should be immediately charged to the customer's account.

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	• There should be a system to ensure that statements are sent regularly and promptly to the customer. • There should be a system to monitor and follow-up customers' payments. • Payments overdue beyond a reasonable period should be identified and attended to carefully. For defaulting customers, credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses. • There should be a system of periodic review of credit card holders' accounts. On this basis, the limits of customers may be revised, if necessary. The review should also include determination of doubtful amounts and the provisioning in respect thereof.



While doing the audit of a branch of XYZ bank for the year ending 31st March 24, it was seen that the stock statements with the same figures are submitted by borrowers month after month with a change in the month at the top. These are just filed for formal compliance. Such things happen because a responsible official does not check the stock statements and get them entered in in the system, which is a lapse in internal control. Due to such a lapse, neither the borrower nor bank staff take it sincerely, thus posing a risk of loss to bank.

6. COMPLIANCE WITH CRR AND SLR REQUIREMENTS

(i) Cash Reserve Ratio (**CRR**) is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank. One of the important determinants of cash balances to be maintained by banking companies and other scheduled banks is the requirement for maintenance of a certain minimum cash reserve.

While the requirement for maintenance of cash reserve by banking companies is contained in the Banking Regulation Act, 1949, corresponding requirement for scheduled banks is contained in the Reserve Bank of India Act, 1934.

The RBI, from time to time, reviews the evolving liquidity situation and accordingly decides the rate of CRR required to be maintained by scheduled commercial banks. Therefore, the auditor needs to refer to the master circular issued from time to time in this regard to ensure the compliance of CRR requirements.

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(ii) Statutory Liquidity Ratio (SLR) Requirements – SLR is the requirement that every scheduled commercial bank in India is required to maintain in the form of certain liquid assets such as gold, cash and government approved securities before providing credit to the customers. The Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements of 12 odd dates in different months of a fiscal year not being Fridays. The objective of maintaining SLR is to have an amount in the form of liquid assets which can be used to handle a sudden increase in demand for the amount from the depositors. The resultant report is to be sent to the top management of the bank and to the Reserve Bank.

Correctness of the compilation of DTL (Demand and Time Liabilities) position; and

Maintenance of liquid assets as prescribed u/s 24 of Banking Regulation Act.

Audit Approach and Procedure:

Area of Focus	Suggested Audit Procedures
Compliance with CRR and SLR requirements	• Obtain an understanding of the relevant circulars/ instructions of the RBI, particularly regarding composition of items of DTL. • Request the branch auditors to send their weekly trial balance as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him/her. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates. • Examine, on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches. The auditor should examine whether the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI. • While examining the computation of DTL, specifically examine that items have been excluded from liabilities as per RBI guidelines. Some of these items are: - ***a) Paid up capital, reserve, any credit balance in Profit and Loss Account of the bank, amount of any loan taken from***

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	the RBI and amount of refinance taken from EXIM Bank, NHB, NABARD, SIDBI. ***b) Bills discounted by a bank with eligible financial institutions as approved by the RBI.*** ***c) Net Income tax provision.*** ***d) Amount received from DICGC towards claims held by banks pending adjustments thereof.*** ***e) Amount received from ECGC by invoking the guarantee.*** ***f) Amount received from insurance companies for ad hoc settlement of claims pending judgement of court.*** ***g) Amount received from court receiver.*** ***h) Net unrealized gain/loss arising from derivatives transactions under trading portfolio.*** ***i) Income flows received in advance such as annual fees and other charges which are not refundable.*** ***j) Liabilities arising on account of utilisation of limit under 'Bankers' Acceptance Facility' (BAF).*** ***k) Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.*** ***l) Amounts received in Indian currency against import bills and held in sundry deposits pending receipt of final rates.*** ***m) Un-adjusted deposits/balances lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payments made by other branches but not adjusted by the link branches.*** ***n) Margins held and kept in sundry deposits for funded facilities.*** • Similarly, specifically examine that the items have been included in liabilities as per RBI guidelines. Some of these items are: -

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	○ Net credit balance in branch adjustment accounts. The credit entries in branch adjustment account which are outstanding for more than 5 years are required to be considered at gross. ○ ***Interest accrued on deposits should be calculated on each reporting fortnight (as per the interest calculation method applicable to various types of accounts), whether or not such interest is accounted for in books of accounts, so that the bank's liability in this regard is fairly reflected in the total NDTL of the same fortnightly return. Cash collaterals received under collateralized derivative transactions as these are in the nature of 'outside liabilities'.*** ○ Borrowings from abroad by banks in India need to be considered as 'liabilities to other' and should be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, the adverse balances in Nostro Mirror Account needs to be considered as 'Liabilities to other'. ○ The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank. ***While examining the computation of DTL, the auditor may specifically examine the details of exempted categories of the following items:*** - ***Minimum Eligible Credit (EC) and outstanding Long-Term Bonds (LB) to finance Infrastructure loans and affordable housing loan, as per RBI Circular.*** - ***The eligible amount of incremental FCNR(B) and NRE deposits of maturities of three years and above. The auditor should also verify loans out of FCNR(B) deposits and inter- bank Foreign Currency (IBFC) deposits for***

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	reporting in Form A return. Banks should convert their foreign exchange assets/liabilities (including borrowings) in USD, GBP, JPY and Euro into INR at RBI reference rate. For other currencies consider the New York rate for conversion into USD. ***As per RBI Circular on "Maintenance of CRR/SLR on Foreign Currency Assets/Liabilities – Reference rate for INR/USD and exchange rate of other major currencies", for conversion of foreign Currency Assets/ Liabilities reference rate from FBIL should be taken. If reference rate is not available from FBIL, banks may continue to use New York closing rate for conversion of such currency into USD.*** • Examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches. • ***The auditor should also, particularly, examine whether the balances in Branch Adjustment Accounts of foreign branches have been taken into account in arriving at the net balance in Branch Adjustment Accounts.*** • ***The auditor should examine the correctness of data in Form A return for CRR and Return in Form VIII for SLR purposes on sample basis.*** • ***As stated in the preceding paragraphs, a considerable part of the information required by the SCA for reporting on compliance with the SLR requirements will flow from the branches. It is suggested that the relevant information pertaining to the branches within a region may be consolidated at the regional level. The auditor of the region concerned should verify the same in the manner described in the above paragraphs and report on the same. The consolidated statement should also be counter-signed by the regional manager. The auditor at the central level should apply the audit procedures listed in the above paragraphs to the overall consolidation prepared for the bank as a whole. Where such a procedure is followed, the SCA should adequately describe the same in his certificate.***

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	• The auditor at the central level should apply the audit procedures listed above to the overall consolidation prepared for the bank as a whole. Where such procedure is followed, the central auditor should adequately describe the same in the report. • While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he/she has relied on the returns received from the unaudited branches in forming an opinion. Recently, there has been introduction of Automated Data Flow (ADF) for CRR & SLR reporting and the auditors should develop necessary audit procedures around this.

7. VERIFICATION OF ASSETS

Before beginning verification of assets and balances, the auditor should obtain an accurate schedule of accounts in the prescribed format. The following are the steps involved in verification of assets and balances. -

I. **CASH, BANK BALANCES AND MONEY AT CALL AND SHORT NOTICE -** The Third Schedule to the Banking Regulation Act, 1949, requires disclosures to be made in the balance sheet regarding cash, balances with Reserve Bank of India, balances with other banks and money at call and short notice. Audit approach and audit procedures in respect of these items is discussed as under: -

Cash	Balances with Reserve Bank of India	Balances with Other Banks	Money at Call and Short Notice

Audit approach: The auditor's basic objective in verification of these items is their existence and completeness as on date of balance sheet and audit procedures have to be tailored to meet these. Remember that cash would be appearing in balance sheet of almost all branches. However, in most of the branches of a bank, there will be no bank account requiring reporting except in branches with treasury operations. Similarly, activity pertaining to money at call and short notice is handled by the treasury department of the bank at head office level.

Banks have a robust system of internal controls pertaining to cash like joint custody of two responsible officers, checking of cash at periodic intervals etc. due to higher risk of misappropriation. Similarly, the balance with other banks (in case of applicable branches) are

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reconciled periodically. The auditor has to be satisfied about effective operation and implementation of internal controls in this area.

Audit Procedures:

Area of Focus	Suggested Audit Procedures
Cash	• Carry out the physical verification of cash (including foreign currency, if any, ***cash at ATM and cash at cash deposit machines***) as close to the balance sheet date as possible. • The cash balance as physically verified should be agreed with the balance shown ***in the cash register/balance in CBS***.
Balance with Reserve Bank of India	• Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end. • Review the reconciliation statements, paying special attention to the following items appearing in the reconciliation statements: ○ Cash transactions remaining unresponded; ○ Revenue items requiring adjustments/write-offs; and ○ Other credit and debit entries originated in the statement provided by RBI remaining unresponded for more than 15 days.
Balance with Other Banks (Other than Reserve Bank of India)	Apart from the procedures described above in examining the balances with Reserve Bank of India, while reviewing the reconciliation statements, the auditor should pay particular attention to the following. • 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. • Examine that no cheque sent or received in clearing is outstanding. • Examine that all bills or outstation cheques sent for collection and outstanding as on the closing date have been credited subsequently.

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	• Examine large transactions in inter-bank accounts to ensure that no transactions have been put through for window-dressing particularly towards the close of year. 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.
Money at Call and Short Notice	• Examine whether there is a proper system of authorisation, 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. • Examine whether the aggregate balances comprising this item as shown in the relevant register tally with the control accounts as per the general ledger. • 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. • Verify that the interest has been properly accrued and accounted for on year-end outstanding balances of call/ short notice money.

II. INVESTMENTS

Audit approach:

The auditor's primary objective in audit of investments is to satisfy himself as to their existence, ownership and valuation. Examination of compliance with statutory and regulatory requirements is also an important objective in audit of investments 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 should 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 audit procedures relating to investments. Every bank has their own

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investment policy, which is drawn strictly in conjunction with RBI Master circular on investments. The entire compliance needs to be evaluated in terms of requirements of investment policy read with master circular RBI.

Audit Procedures:

Area of Focus	Suggested Audit Procedures
Internal Control Evaluation and Review of Investment Policy	• 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. • It should clearly outline the broad investment objectives separately for the investments on its own account and investments on behalf of customers.
Separation of Investment Functions	• Check the segregation of duties within the bank staff in terms of executing trades, settlement and monitoring of such trades, and accounting of the same (generally termed as front office, middle office and back-office functions' segregation).
Examination of Reconciliation	• Examine the reconciliation of the investment account, physically verify the securities on hand, obtain confirmations from counter-party banks for Bank Receipts (BRs) issued by such banks and on hand, obtain confirmation of Subsidiary General Ledger (SGL) balances with the Public Debt Office (PDO), and examine the control and reconciliation of BRs issued by the bank.
Examination of Documents	• Ascertain whether the investments made by the bank are within its authority. • Ensure that any other covenants or conditions which restrict qualify or abridge the right of ownership and/or disposal of investments, have been complied with by the bank. • The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence.
Physical Verification	• Verify the investment scrips physically at the close of business on the date of the balance sheet. • Verify investments held with public debt office of RBI, custodians and depository with the statement of holdings as

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	on date of balance sheet. Independent balance confirmation requests can be made in accordance with SA-505. In case independent confirmations are not received back, alternative audit procedures like getting bank personnel to download investment statement from E-Kuber for government securities (E-Kuber is CBS platform of RBI) in auditor's presence can be designed. • In respect of BRs issued by other banks and on hand with the bank at the year-end, the auditor should examine confirmations of counterparty banks about such BRs. Where any BRs have been outstanding for an unduly extended period, the auditor should obtain written explanation from the management for the reasons thereof. The auditor should examine the reconciliation of BRs issued by the bank. BRs should not be issued in respect of transactions in government securities for which SGL facility is available. • If certain securities are held in the names of nominees, the auditor should examine whether there are proper transfer deeds signed by the holders and an undertaking from them that they hold the securities on behalf of the bank.
Examination of classification and shifting	• Examine that entire investment portfolio of bank is classified under three categories i.e.HTM, HFT and AFS and shifting of securities is as per regulatory norms and laid down policy. • Examine whether the shifting of the investments from 'available for sale' to 'held to maturity' is duly approved by the Board of Directors of the bank.
Examination of Valuation	• Examine whether the method of accounting followed by the bank in respect of investments, including their year-end valuation, is appropriate. • Examine whether the investments have been properly classified into the three categories at the time of acquisition based on such intention as evidenced by the decision of the competent authority such as the Board of directors, Asset Liability Committee (ALCO) or Investment Committee. • Examine compliance by the bank with the guidelines of the RBI relating to valuation of investments. • Verify that investments are classified as non-performing investments (NPI) as per applicable RBI guidelines. (Non-performing investments are those where interest/principal is in arrears and remains unpaid for more than 90 days). In such

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	cases, banks have not to reckon income on securities and are required to make provisions for depreciation in value of investment. • Examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the bank has opted for receipt of income through the electronic/online medium. • Verify whether adequate disclosure of any change in method of valuation of investment is made. • Examine whether the profit or loss on sale of investments has been computed and accounted for properly. • Verify that there is a proper system for recording and maintenance of TDS certificates received by the bank.
Dealings in Securities on Behalf of Others	• Examine whether prior approvals for carrying out such dealings have been obtained. • Examine whether the bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. • Consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets.
Special-purpose Certificates Relating to Investments	• Examine whether the bank is maintaining separate accounts for the investments made by it on their own Investment Account, on PMS clients' account, and on behalf of other constituents (including brokers). • As per the RBI guidelines, banks are required to get their investments under PMS separately audited by external auditors.

Audit, Review and Reporting: Banks should undertake half-yearly reviews (as of 30th September and 31st March) of their investment portfolio. These half yearly reviews should not only cover the operational aspects of the investment portfolio but also clearly indicate amendments made to the investment policy and certify the adherence to laid down internal investment policy and procedures and RBI guidelines.

The internal auditors are required to separately conduct the concurrent audit of treasury transactions, and the results of their report should be placed before the CMD once every month. Banks need not forward copies of the internal audit report to RBI. However, major irregularities

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observed in these reports and position of compliance thereto may be incorporated in the half yearly review of the investment portfolio.

III. ADVANCES

The Third Schedule to the Act requires classification of advances made by a bank from three different angles, *viz.*, nature of advance (like cash credit, overdrafts or term loans or bills purchased and discounted), nature and extent of security (like secured by tangible assets or covered by bank/govt guarantees), and place of making advance (i.e. Whether in India or outside India). Further, advances in India are also to be classified also on sectoral basis (like priority sector or public sector).

Audit Approach: Advances generally constitute a major part of the assets of the bank. There are substantial number of borrowers to whom variety of advances are granted. The audit of advances requires major attention from the auditors. The auditor is primarily concerned with obtaining evidence about the following while carrying out audit of advances: -

- Amounts included in the balance sheet in respect of advances are outstanding at the date of balance sheet
- Advances represent amounts due to the bank
- Amounts due to the bank are appropriately supported by loan documents
- There are no unrecorded advances
- The stated basis of valuation of advances is appropriate and properly applied and recoverability of advances is recognized in their valuation.
- Advances are disclosed, classified and described in accordance with recognized accounting policies and practices and relevant statutory and regulatory requirements
- Appropriate provisions towards advances are made as per RBI norms, accounting standards and generally accepted accounting practices

It would be worth recalling that there exists an elaborate and detailed control system & procedure in banks pertaining to appraisal, sanctioning, documentation, disbursal, review, monitoring and supervision of advances. Audit approach of advances should encompass designing appropriate audit procedures to obtain audit evidence in all these areas.

Audit Procedures - In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

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Area of Focus	Suggested Audit Procedures
Evaluation of Internal Controls over Advances	• Examine area of credit appraisal and verify whether laid down procedures regarding credit appraisals including loan applications, preparation of proposals, obtaining satisfaction about credit worthiness of borrowers are being followed; • Examine advances are sanctioned according to delegated authority; • Examine all necessary loan documents have been executed after sanction but before disbursals are made to borrowers; • Examine compliance with stipulated terms of sanction and end use of funds more particularly in case of term loans; • Examine existence, enforceability and valuation of securities. In respect of securities requiring registration, examine this area also; • Examine the validity of the recorded amounts; • Review operations of the accounts and look for adverse features like unauthorised over drawings beyond limits; • Examine whether system laid down in bank for review/renewals of advances is being followed; • Review whether drawing power is being calculated properly on basis of stock/book debt statements received from borrowers as stipulated in respective sanction letters; • Ensure compliance with Loan Policy of Bank as well as prudential norms of RBI including appropriate asset classification and provisioning.
Substantive Audit Procedures	• Verify correctness of master data of loan accounts updated in CBS. Check parameters like instalments, EMI, rate of interest, tenure of loans etc. • Verify that each customer of bank is tagged under single customer id in respect of all its accounts including those in which credit facilities are granted. • Examine all large advances while other advances may be examined on a sample basis. • Examine accounts identified to be problem accounts but which have not yet slipped into NPA category. This can be done by obtaining list of SMA1 and SMA2 borrowers from the bank and

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	same can be considered for selection of problematic accounts. • Examine those accounts which have been adversely commented upon by concurrent auditors/bank's internal inspection/RBI inspection team. • Examine list of restructured accounts to ensure that restructure is as per RBI guidelines. Remember restructured account portfolio requires additional provisioning. • Examine quick/early mortality accounts. Any advance slippage to NPA within 12 months of its sanction is called as quick/early mortality case. • Verify completeness and accuracy of interest being charged. • Carry out appropriate analytical procedures.
Recoverability of Advances	• Review periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions. • Review latest financial statements of borrowers. • Review reports on inspection of security. • Review auditor's reports in case of borrowers having credit facilities from the banking system beyond a cut-off limit fixed by board of directors of bank



FT Cooperative Bank lent a housing loan of ₹ 1 crore to Rahul, for an under construction flat. The project was still incomplete, and the builder absconded. It turned out that the builder had taken a loan from another bank for the entire property on the basis of an equitable mortgage. Since equitable mortgage is not registered, FT bank was unable to trace the loan taken by the builder and therefore the borrower Rahul and FT bank both suffered.

It would be a better idea to first approve the builder after thoroughly examining his credentials, past performances etc., and then only consider giving loans to buyers of his flats to minimize such risks. In fact, many banks nowadays do this. Somehow FT Coop bank did not take the precaution and landed in trouble. Further, CIBIL records of the builder also could have been checked. Loan sanctioning should not become a mere "tick the box" process.

Verification of asset classification, income recognition and Provision for Non-performing assets: An important aspect of audit of advances relates to their asset classification and provisioning

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(for provisioning norms refer Chapter Audit of Banks of Intermediate Auditing & Ethics Study Module). This implies that advances are classified in accordance with prudential norms on asset classification, income is recognized on actual record of recovery and a proper provision should be made in respect of advances where the recovery is doubtful.

Audit approach

The Reserve Bank has prescribed objective norms for determining the quantum of provisions required in respect of advances. The auditors must take / download the latest Master Circular of RBI to familiarise himself fully with the norms prescribed by RBI in this regard. The circulars issued by RBI after the date of issue of Master Circular and till the date of audit should also be taken / downloaded and reviewed by the auditors for its adherence. However, these norms should be construed as laying down the minimum provisioning requirements and wherever a higher provision is warranted in the context of the threats to recovery, such higher provision should be made.

In this regard, the provisions of section 15 of the Banking Regulation Act, 1949 may be noted. This section, which applies to banking companies, nationalised banks, State Bank of India and regional rural banks, requires the bank concerned to make adequate provision for bad debts to the satisfaction of its auditor before paying any dividends on its shares.

It may be noted that verification of applicable prudential norms on asset classification, income recognition and provisioning is an important responsibility of statutory branch auditor as well as statutory central auditor.

Area of Focus	Suggested Audit Procedures
Classification and Provision	• Verify whether bank has a system of ongoing identification and classification of advances through CBS without manual intervention and its accuracy in crystallising date of NPA. • Examine whether the classification made by the branch is appropriate. Particularly, examine the classification of advances where there are threats to recovery. • Examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly. • Review and compare the date of NPA of loan accounts mentioned in current year statements with that of previous year. Reasons for any change should be ascertained.

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Accounts regularized near Balance sheet date	As per the Reserve Bank guidelines, if an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources, the account need not be treated as NPA. Where, subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should carefully assess whether the repayment was out of genuine sources or not. Where the account indicates inherent weakness based on the data available, the account should be deemed as NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status. It is to be ensured that the classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date. The date of NPA is significant to determine the classification and hence specific care be taken in this regard. NPA should be recognized only based on concept of Past Due/ Overdue concept, and not based on the Balance Sheet date.
Drawing Power Calculation	• Ensure that the drawing power is calculated as per the extant guidelines (i.e. the Credit Policy of the Bank) formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors reflected from respective sanction letters. • Special consideration should be given to proper reporting of sundry creditors and stocks covered under LCs/guarantees for the purposes of calculating drawing power. It is to be ensured that declared stocks shall not cover borrower's liability outstanding in form of sundry creditors for goods or covered by LCs/guarantees availed for procurement of material. Similarly, in case bank has provided credit facility against primary security of book debts, net value of debtors (i.e. eligible trade debtors as per terms of sanction less bills discounted with banks) is to be arrived at. It is to be ensured that drawing power is calculated net of stipulated margin. Further, in case of consortium accounts, drawing power calculation and allocation made by lead bank is binding on member banks. • The drawing power needs to be calculated carefully in case of working capital advances to companies engaged in

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	construction business. The valuation of work in progress should be ensured in consistent and proper manner. It also needs to be ensured that mobilization advance being received by the contractors is reduced while calculating drawing power. • The stock audit including audit of book debts should be carried out by the bank for all accounts having funded exposure of more than stipulated limit. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.
Accounts with temporary deficiencies	• Banks should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of drawing power based on latest available stock statement, balance outstanding exceeding the limit temporarily and non-renewal of limits on the due date. However, stock statements relied upon by the banks for determining drawing power should not be older than 3 months. The outstanding in the account based on drawing power calculated from stock statements older than 3 months are considered as irregular. Ensure adherence to these guidelines.
Limits not reviewed	• Accounts where regular/ad hoc limits are not reviewed within 180 days from the due date/date of ad hoc sanction, should be considered as NPA. Auditors should also ensure that the ad hoc/short reviews are not done on a repetitive basis. In such cases, auditor can consider the classification of account based on other parameters and functioning of the account.
Asset classification to be borrower wise and not facility wise	• Ensure that asset classification is borrower wise and not facility wise. Therefore, it is to be ensured that all the facilities granted by a bank to borrower will have to be treated as NPA and not particular facility which has become irregular. Further, if debits arising out of devolvement of LC or invoked guarantees are kept in separate account, the outstanding balance should be treated as part of borrower's principal account for purpose of application of prudential norms on asset classification, income recognition and provisioning.

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Government Guaranteed Advances	• If government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not be taken to income unless interest is realized. However, for the purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked. This exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days. • In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.
Agricultural Advances	• Ensure that NPA norms have been applied in accordance with the crop season determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops – short term/ long term - raised by an agriculturist, the NPA norms would also be made applicable to agricultural term loans availed of by them. Also ensure that these norms are made applicable to all direct agricultural advances listed in Master Circular on lending to priority sector. • In respect of agricultural loans, other than those specified in the circular, ensure that identification of NPAs has been done on the same basis as non-agricultural advances.
Provisioning Towards Standard Assets	The auditor should check the latest RBI Circulars in this regard. It is be understood that provision for standard assets is also required to be made at variable rates in respect of different sectors for the funded outstanding in accordance with RBI norms as a matter of prudence. The provisions need to be checked in detail with the statement of advances. The bifurcation of standard advances under relevant category for proper calculation of provision should be checked and certified at branches level. The definition of respective items specified should be adhered as defined by RBI.
Restructured Advances	Restructuring is an act in which a lender, for economic or legal reasons relating to borrower's financial difficulty, grants concessions to the borrower. It may involve modification of terms of advances including alteration of amount of instalments/alteration of repayment period/rate

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	of interest/sanction of additional credit facilities etc. to help in curing default. RBI has given revised guidelines for treatment of restructured accounts by its circular. The auditor should verify compliance with the requirements of the circular issued in this regard. Banks may restructure the accounts classified under standard, substandard or doubtful categories. Banks cannot restructure accounts with retrospective effect. Once the bank receives an application/proposal in respect of an account for restructuring, it implies that the account is intrinsically weak. Accordingly, during the time the account remains pending for restructuring, the auditors need to take a view whether provision needs to be made in respect of such accounts, pending approval for restructuring. On restructuring, the account will be downgraded from Standard to substandard. NPAs will remain in the same category.
Upgradation of Account	Examine all the accounts upgraded from NPA to standard category during the year, to ensure that the upgrading of each account is strictly in terms of RBI guidelines. There can be a possibility of incorrect upgradation of account on the basis of partial recoveries made in the account and overdue portion might not have wiped out completely. There can also be a possibility of recoveries being made in the account after cut-off date and account being upgraded as on date of balance sheet.
Sale/ Purchase of NPAs	**In case of Sale/Purchase of NPA by Bank, the auditor should examine:** • the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers including non-performing financial assets that may be purchased/sold, norms or such purchase/sale, valuation procedure and accounting policy. • only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years. • the assets have been sold/ purchased "without recourse' only i.e the entire credit risk associated with the non-performing asset should be transferred to the purchasing bank.

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	• subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs. • the NPA has been sold at cash basis only. Under no circumstances, NPA can be sold to another bank at a contingent price. The entire sale consideration has to be received on an upfront basis. • the bank has not purchased an NPA which it had originally sold. **In case of sale of an NPA, the auditor should also ensure that:** • on the sale of the NPA, the same has been removed from the books of the account of selling bank on transfer. • If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year. • If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/ loss on account of sale of other non-performing financial assets. **Similarly, in case of purchase of NPAs, the auditor should verify that:** • the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the purchasing bank. • any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit. • for the purpose of capital adequacy, banks have assigned 100% risk weights to the NPAs purchased from other banks.

TEST YOUR UNDERSTANDING 1

CA Harshit is conducting statutory audit of branch of a public sector bank. On examining 20 large advances of the branch, he finds that in 5 examined cases, loan applications have been filled up incompletely with important details left out. In these cases, it is also noticed that cash credit limits to

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the borrowers were enhanced during the year but there are no records pertaining to assessment of enhanced working capital requirements in respective borrower files. The branch is unable to show such assessments/workings in system either.

However, all the five accounts are operating satisfactorily. These accounts have been classified as standard assets by branch. Would the above information prompt auditor to suggest change in asset classification of above accounts? What does the depicted situation reflect?

IV. FIXED ASSETS

The Third Schedule to the Banking Regulation Act, 1949 requires fixed assets to be classified into two categories in the balance sheet, *viz.,* Premises and Other Fixed Assets. Premises wholly or partly owned by the banking company for the purpose of business including residential premises used by employees of bank are shown under the head "Premises". Other fixed assets include furniture & fixture, motor vehicles, computers, office equipment etc. Though not specifically mentioned under the Banking Regulation Act, 1949, the assets taken on lease and intangible assets should be shown separately for proper classification and disclosure and also to comply with the requirements of the Accounting Standards (ASs).

Section 9 of the Banking Regulation Act, 1949, prohibits 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.

Audit Approach: In most of the banks, fixed assets are generally purchased by the head office or regional/zonal offices. Statutory branch auditor has to ascertain the procedure followed and plan accordingly. In most of the banks, maintenance of records is centralized at head office level. In some of the banks, information relating to the purchase and sale of fixed assets is accounted for with help of Fixed asset management software. The audit procedures have to be designed accordingly.

Audit Procedures

In carrying out the audit of fixed assets, the auditor is concerned primarily with obtaining evidence about their ownership, existence and valuation. For this purpose, the auditor should review the following:

Area of Focus	Suggested Audit Procedures
Internal Controls	Examine the system of internal controls broadly covering the following: • Control over expenditures incurred on fixed assets acquired or self-constructed.

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	• Accountability and utilisation controls. • Information controls for ensuring availability of reliable information about fixed assets. • Ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. • Ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. • Examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office.
Premises	• 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 authorisation and documents such as, contractors' bills, work order records and records of payments. • 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 amortised over their balance useful 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 the 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/ payments to contractors for such assets should be shown under a separate item under the head "fixed assets". • 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 relevant Accounting Standard. The auditor should also check the impairment, if any, by applying the principles laid down in relevant Accounting Standard.

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	• 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, e.g., their physical verification at periodic intervals by the branch management and/or by inspection/internal/concurrent audit team. The auditor should also examine whether discrepancies have been properly dealt with in the books of account and adequate provision in respect of any damaged assets has been made with appropriate approvals. • In the case of transfer of fixed assets, like furniture, office equipment, etc. from one branch to another; the auditor should examine whether accumulated depreciation in respect of such assets is also transferred. • In case of intangible assets, verify whether the relevant guidelines given by RBI by way of Circulars and the requirements of AS 26 have been followed. • Examine whether fixed assets have been properly classified. Fixed assets of similar nature only should be grouped together. **Example:** Items like safe deposit vaults should not be clubbed together with the office equipment's or the theft alarm system of the bank. • Examine whether any expenditure incurred on a fixed asset after it has been brought to its working condition for its intended use, has been dealt with properly. • The auditor at head office level should examine if the consolidated fixed assets schedule matches in all respects and all the transfers in/out are tallied. A broad check on the depreciation amount vis-a-vis the gross block of assets be reviewed with special emphasis on the computer hardware/software.
Sale of Fixed Assets	• Verify the copy of sale deed and receipt of the sale value, in respect of fixed assets sold during the year. Ensure that the profit/ loss on sale of assets has been properly accounted for.

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Leased Assets	• Verify accounting and provisioning norms to be followed by banks undertaking leasing activity in accordance with RBI circulars and guidelines. The auditor, in respect of leased assets, should also have regard to the requirements of AS 19, "Leases".
Impairment of Assets	• Verify whether the guidelines given by RBI's circular on compliance with Accounting Standards, and the requirements of AS 28 have been followed.

V. OTHER ASSETS: The auditor may carry out the audit of various items appearing under the head 'other assets' in the following manner:

Audit Procedures

Area of Focus	Suggested Audit Procedures
Inter-Office Adjustments	Examine whether Inter-branch accounts are normally reconciled at the central level. The auditor should report on the year-end status of inter-branch accounts, indicating the dates up to which all or any segments of the accounts have been reconciled. The auditor should also indicate the number and amount of outstanding entries in the inter branch accounts, giving the relevant information separately for debit and credit entries. The auditor should ensure that any discrepancies found in inter-branch accounts have been properly dealt with in the books. The auditor can obtain the relevant information primarily from branch audit reports.
Interest Accrued	• Examine whether the interest has been accrued on the entire loans and advances portfolio of the bank. Special consideration should be given to the overdue bills purchased/discounted. • Ensure that only such interest as can be realised in the ordinary course of business should be shown under this head. This is based on the principle, recognised in AS 9, that revenue cannot be recognised if there is a significant uncertainty about its collectability.
Tax Paid in Advance/Tax Deducted at Source	• Ensure that the certificates for such tax deducted at source are 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 a periodic basis as defined. • TDS Certificates / credits in the Form 26AS and claim of the same in Income Tax returns filed should be checked to ensure the justification of the claim towards such certificates. • At Head Office level, the availability of all the TDS Certificates / credits in the form 26 AS and claim of the same in Income Tax returns filed

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	should be checked to ensure the justification of the claim towards such certificates.
Stationery and Stamps	• Ensure that the item "Stationery and Stamps" includes only exceptional items of expenditure on stationery like bulk purchase of security paper which is to be written off over a period of time. Such items should be valued at cost. Normal expenditure on stationery is charged to profit & loss account. Therefore, this item may not appear at branch level as a considerable part of stationery is supplied to branches by head office. • Evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of audit. It may be noted that the branch auditor is required to specifically comment on the adequacy of the relevant internal controls in the LFAR. • 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. • 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.
Non-Banking Assets Acquired in Satisfaction of Claims	• Ensure that the heading includes those immovable properties/tangible assets which the bank has acquired in satisfaction of debts due or its other claims and these are being held with intention of being disposed off. • 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. • Check that the ownership of the property is legally vested with 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. In case 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, Contingent Liabilities and Contingent Assets". • Ensure compliance with Section 9 of Banking Regulation Act, on holding period of such assets. • Ensure that as at date of acquisition, the assets should be recorded at lower of net book value of advance or net realisable value of asset acquired.

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VI. OTHERS

This is the residual heading, which will include items not specifically covered under other sub-heads, e.g., claims which have not 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 procedures relating to some of the major items included under this head are discussed below:

Audit Approach and Procedures

Area of Focus	Suggested Audit Procedures
Non-Interest-Bearing Staff Advances	• Examine non-interest-bearing staff advances with reference to the relevant documentation and the policy in this regard which is framed by the bank. The availability, enforceability and valuation of security, if any, should also be examined. • Ensure that the same relates to employees on the rolls of the bank on the date of the preparation of financial statements.
Loans and Advances to Officials and Relatives	• The auditor should verify that loans have been ordinarily sanctioned by the next higher sanctioning authority as compared to the recipient of loan. • Loans to senior officers or of higher amount should have been reported to the Board.
Security Deposits	• Examine security deposits with various authorities (e.g., on account of telephone, electricity, etc.,) and with others (e.g., deposits in respect of premises taken on rent) with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. • Ensure that the deposit amount has not become due as per the terms and conditions. If it is so, then the recoverability of the same needs to be considered in detail and appropriate provision be made against the amount which is doubtful to recover.
Suspense Account	• Obtain from the management details of old outstanding entries in suspense account along with reasons for delay in adjusting the entries. Where the outstanding balances comprised in suspense account require a provision/write-off, the auditor should examine whether the necessary provision has been made/write-off.

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Prepaid Expenses	• Examine whether the basis of allocation of expenditure to different periods is reasonable. • Examine whether the allocation of discounting and rediscounting charges paid by the bank to different accounting periods is in consonance with the accounting policy followed for the bank as a whole.
Miscellaneous Debit Balances on Government Account	• Review the ageing statements pertaining to these items. • Examine the recoverability of old outstanding items. • Examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant terms and conditions. The net balances of the amount recoverable at the Head Office level should also be taken along with the age-wise analysis of the same. In the case of old outstanding balances without any confirmation or proper justification of the same, should be provided for in the accounts. • For major variance as compared to the previous year figures, verify whether reasons for the same have been recorded and reviewed.

8. VERIFICATION OF CAPITAL & LIABILITIES

I. CAPITAL

The auditor may carry out the audit of various items under 'Share Capital' in the following manner:

Audit Approach and Procedures

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 authorised 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, returns filed with the Registrar of Companies etc.

Capital Adequacy: The term 'capital adequacy' is used to describe the adequacy of capital resources of a bank in relation to the risks associated with its operations.

Adequacy of capital of banks has been the subject matter of consideration by banking authorities around the world for several decades. An international agreement on a common risk-based capital

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framework and definition of bank capital was framed by the Committee on Banking Regulations and Supervisory Practices of the G-1O Nations (popularly known as the Basel Committee) and was formally adopted in 1988. Basel accords and frameworks were borne out of these deliberations.

The framework attempted to relate a bank's capital needs to its risk profile. Besides serving to strengthen the soundness and stability of the banking system, it also sought to give banks an incentive to hold lower-risk assets, incorporate off-balance sheet exposures explicitly into capital assessments, and achieve greater uniformity in application of capital standards to banks across different countries.

8.1. Stress Testing

RBI has required that all commercial banks (excluding RRBs and LABs) shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems. Stress tests are designed to understand whether a bank has enough capital to survive plausible adverse economic conditions and to maintain enough buffer to stay afloat under extreme scenarios.

8.2 BASEL III framework

Basel III norms relate to the Capital Adequacy requirement compliance which the Bank has to achieve as contained in the BASEL III accord. Basel capital adequacy norms are meant for the protection of depositors and shareholders by prescriptive rules for measuring capital adequacy, thereby evolving methods of determining regulatory capital and ensuring efficient use of capital.

Basel III accord strengthens the regulation, supervision and risk management of the banking sector. It is a global regulatory standard on capital adequacy of banks, stress testing as well as market liquidity risk.

The Basel III accord, aims at:

(a) improving the banking sector's ability to absorb shocks arising from financial and economic stress, irrespective of reasons thereof;

(b) improving risk management and governance practices; and

(c) strengthening banks' transparency and disclosure standards.

Capital Adequacy Measures in India: In India, the statutes governing various types of banks lay down the minimum capital requirements for them. Besides, there are also requirements for maintenance of statutory reserves. Considering the variations in minimum capital requirements applicable to distinct types of banks and taking into account the approach adopted by Basel

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Committee, the Reserve Bank prescribed, in year 1992, a uniform methodology for determining the capital adequacy of scheduled commercial banks (other than regional rural banks). The Master Circular on "Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF)", provides the guidelines to be followed by banks for capital adequacy. Some of the important aspects of the circular are covered below.

The basic approach of capital adequacy framework is that a bank should have sufficient capital to provide a stable resource to absorb any losses arising from the risks in its business. Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument. For supervisory purposes capital is split into two categories: Tier I and Tier II, representing different instruments' quality as capital.

- ***Tier I capital*** consists mainly of share capital and disclosed reserves, and it is a bank's highest quality capital because it is fully available to cover losses.
- ***Tier II capital*** consists of certain reserves and certain types of subordinated debt. The loss absorption capacity of Tier II capital is lower than that of Tier I capital.

Components of Capital: The Master Circular on Capital Adequacy discusses the Capital Funds in two categories – capital funds for Indian banks and capital funds of foreign banks operating in India.

In case of foreign banks operating in India, RBI's Master Circular on Capital Adequacy also lays down certain additional provisions in respect of capital to be followed by such banks.

Capital Risk Adequacy Ratio (CRAR): The CRAR is computed as follows:

$$\frac{\text{Eligible Total Capital Funds}}{\text{Risk weighted assets and off-balance sheet items}} \times 100$$

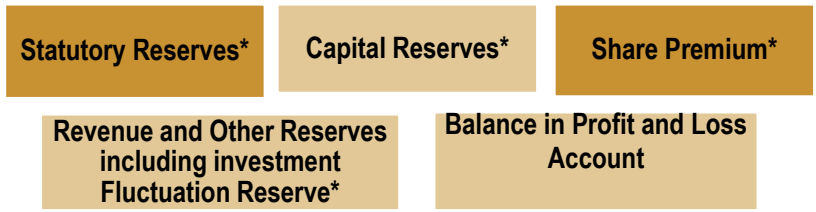
The RBI requires banks to maintain a minimum CRAR of 9 per cent on an ongoing basis. The Master Circular on Capital Adequacy contains detailed guidelines on calculation of risk weighted assets and off-balance sheet items for CRAR.

Example 4: For secured housing loans up to ₹ 75 lakh, the risk weight, subject to some conditions is 50%.for those above ₹ 75 lakhs, it is 75%, for loans to commercial real estate , it is 100%.Thus for a housing loan of ₹ 60 lakh given by the bank, the risk weighted asset will be taken at 60 x 50% = ₹ 30 lakhs for the purpose of the denominator in the above formula.

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II. RESERVES AND SURPLUS

The following are required to be disclosed in the balance sheet under the head 'Reserves and Surplus'.



*In respect of these items above, opening balance, additions during the year and deductions during the year are to be shown separately in respect of each item.

Audit Approach and Procedures

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 share premium, compliance with legal requirements should also be examined. Thus, the auditor should specifically examine whether the requirements 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 share premium account conform to the relevant legal requirements. Compliance with foreign laws in respect of overseas branches needs to be verified by the auditor.

III. DEPOSITS

Audit Approach

Deposits represent the important source of funds for banks. 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 following areas should be considered when auditing Deposits:



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Remember that deposits accepted by banks are primarily of two types i.e those repayable on demand and those repayable after a fixed term. Current and saving accounts are the most common form of demand deposits. Term deposits (fixed deposits etc. known under different nomenclature in different banks) are repayable after a specified period of time ranging from 7 days at present to say one year or five years. Recurring deposits are also an important variant of term deposits in which a specified sum is deposited in the account at regular intervals for a pre-determined period. At maturity, proceeds are repaid to depositors along with interest.

Deposits designated in foreign currencies e.g. foreign currency non-resident deposits (FCNR) are accounts which are opened by Non-resident Indians in form of fixed deposit only.

Besides, there are some accounts like NRE [Non-Resident (External)Rupee account scheme] and NRO [Non-Resident Ordinary Rupee account scheme]. NRE accounts may be opened by Non-Resident Indians and persons of Indian origin. NRO accounts may be opened by all non-residents. These accounts may be maintained in form of savings, current, recurring or fixed deposit and are denominated in Indian Rupees.

Deposits would appear in the balance sheet of most of the branches. Hence, these are of concern to auditors at branch and central/head office level.

Audit Procedures:

The auditor may verify various types of deposits in the following manner:

Area of Focus	Suggested Audit Procedures
Current and saving accounts	• Verify on a sample basis current account and saving accounts opened during the year for adherence to KYC norms. Verify that saving accounts are opened in name of individuals, HUF, some approved institutions like trusts, educational institutes etc. Remember that saving accounts are not opened for business or professional concern. The business transactions are carried in current accounts which can be opened for all kind of customers like companies, individuals, partnership firms etc. • Verify the balances in individual accounts on a sample basis. • Check the calculations of interest on a test check basis. Remember that no interest is paid generally on current accounts by banks. • Examine whether the procedure for obtaining balance confirmation periodically has been followed consistently. Examine, on a sampling basis, the confirmations received. • Ensure that debit balances in current accounts are not netted out on

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	the liabilities side but are appropriately included under the head 'advances'. • Inoperative accounts (both current and saving) are a high-risk area of frauds in banks. As per RBI guidelines, a savings/ current account should be treated as inoperative/dormant if there are no transactions in the account for over a period of two years. Verify on a sample basis some of inoperative accounts revived/closed during the year. Ensure that inoperative accounts are revived only with proper authority. In this regard, cases where there is significant reduction in balances of such accounts as compared to previous year, examine authorisation for withdrawals.
Term deposits	• Examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the registers. • Verify in case of bulk deposits (₹ 2 crore and above for scheduled commercial banks presently), correct rate of interest has been offered. • In case of closure of term deposit, test check whether required foreclosure penalty has been deducted from applicable rate of interest payable. • Verify on sample basis some of recurring deposit accounts opened during the year. • Verify correctness of rate of interest on term deposits on sample basis.
Deposits designated in foreign currencies	• Verify some of FCNR accounts opened during the year on sample basis and ensure these conform to RBI directions. • Verify on sample basis permissible credits and debits in FCNR accounts as per RBI directions. • In case of FCNR accounts, examine whether these have been converted into Indian Rupees at rate notified in this behalf by head office. • Examine whether any resultant increase or decrease has been taken to the profit and loss account. • Verify that interest on deposits has been paid on the basis of 360 days in a year.
Others	• In case of NRE and NRO accounts, verify on a sample basis credits and debits as per RBI guidelines. Also check repatriability". NRE accounts are repatriable whereas NRO accounts are not repatriable except for all current income subject to certain conditions.

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General	• Verify that deposits of a bank are not inflated for purpose of balance sheet presentation. For example, some customers might be given overdrafts near date of balance sheet and the resultant overdrawn amounts may be placed as deposits with banks and further advances may be given on strength and security of these deposits. It would lead to inflated deposits as well as advances. The transactions may be reversed after close of the year. In such cases which indicate the possibility of window-dressing, the auditor should consider making a suitable qualification in main audit report besides other applicable reporting. • 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'. • Ensure that framework relating to 'Know Your Customer' and Anti-Money Laundering measures is formulated and put in place by the bank.

IV. BORROWINGS

Audit approach

Borrowings of a bank are required to be shown in the balance sheet as follows.



The total amount of secured borrowings included under the above heads is to be shown by way of a note to the relevant schedule. Secured borrowings for this purpose include borrowings/refinance in India as well as outside India. It may be noted that the inter-office transactions are not borrowings and therefore, should not be presented as such.

Audit Procedures:

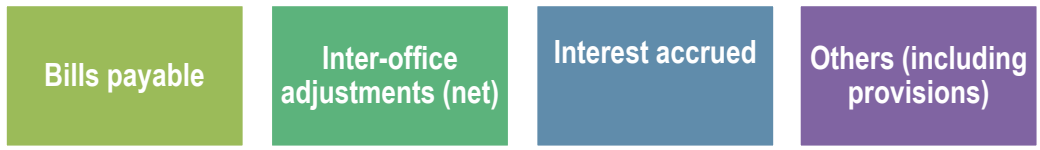
Area of Focus	Suggested Audit Procedures
Borrowings	• Obtain and verify confirmation certificates and other supporting documents such as agreements, correspondence, etc. • External confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of

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	material misstatement. The auditor is required to comply with the requirements of SA 505 "External Confirmations" which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence. • Examine whether a clear distinction has been made between 'rediscount' and 'refinance' for disclosure of the amount under the above head since rediscount does not figure under this head. • Examine whether borrowings of money at call and short notice are properly authorised. The rate of interest paid/payable on, as well as duration of such borrowings should also be examined by the auditor. • Examine the relevant correspondence or other documents to ensure that the branch has been authorised by the Head Office to borrow/retain other borrowings and that the terms on which borrowings have been made are in accordance with the authorisation. • Examine whether the amount shown in the branch accounts is properly classified based on security or otherwise.

V. OTHER LIABILITIES AND PROVISIONS

The Third Schedule to the Banking Regulation Act, 1949, requires disclosure of the following items under the head 'Other Liabilities and Provisions'.



Audit Procedures:

The auditor may verify the various items under the head 'other liabilities and provisions' in the following manner.

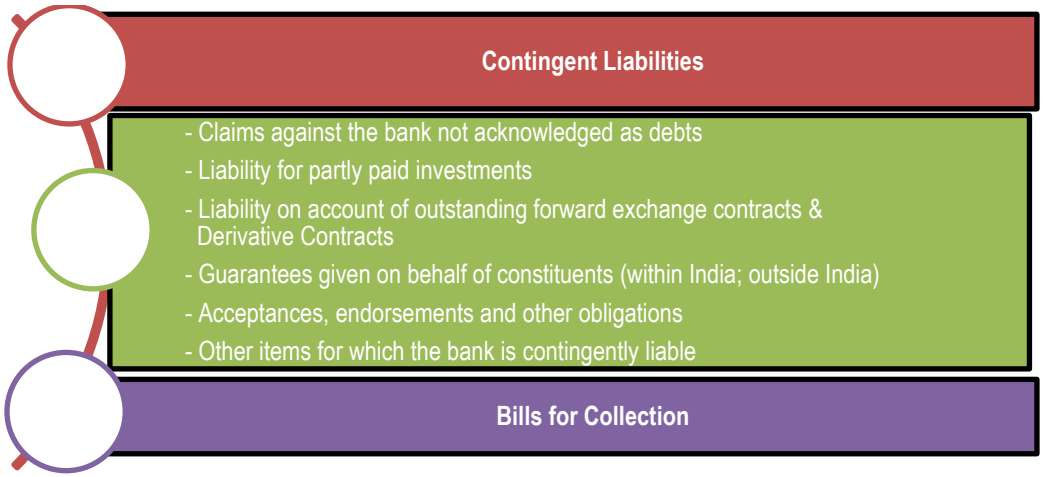
Area of Focus	Suggested Audit Procedures
Bills Payable	Evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following- • Drafts, mail transfers, traveller's cheques, etc. should be made out in standard printed forms. • Unused forms relating to drafts, traveller's cheques, etc. should be kept under the custody of a responsible officer.

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	• 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. • The signatures on a demand draft should be checked by an officer with the specimen signature book. • All the telegraphic transfers and demand drafts issued by a branch should be immediately confirmed by advice to the branches concerned. On payment of these instruments, the paying branch should send a debit advice to the originating branch. 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 advice) should be examined specially in so far as large value items outstanding on the balance sheet date are concerned.
Inter-office Adjustments	The balance in inter-office adjustments account, if in credit, is to be shown under this head.
Interest Accrued	Examine interest accrued with reference to terms of the various types of deposits and borrowings. It should be specifically examined that such interest has not been clubbed with the figures of deposits and borrowings shown under the head 'Deposits and Borrowings'.
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 to 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.

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VI. CONTINGENT LIABILITIES



Audit Approach

In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. The auditor should obtain a representation from management that:-

(i) all off-balance sheet transactions have been accounted in the books of accounts as and when such transaction has taken place;

(ii) all off balance sheet transactions have been entered into after following due procedure laid down;

(iii) all off balance sheet transactions are supported by the underlying documents;

(iv) all year end contingent liabilities have been disclosed;

(v) the disclosed contingent liabilities do not include any crystallised liabilities which are of the nature of loss/ expense and which, therefore, require creation of a provision/adjustment in the financial statements;

(vi) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of Accounting Standard 29, including consideration of the possibility of any reimbursement;

(vii) 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 advances to meet the liability consequent upon the invocation

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of the said guarantee(s) and that no violation of section 20 of the Banking Regulation Act, 1949 has arisen on account of such guarantee; and

(viii) 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 a decision in respect of those contingent liabilities.

Audit procedures

To this end, the auditor should generally follow the audit procedures given below:

Area of Focus	Suggested Audit Procedures
Contingent Liabilities	• 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. • Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so and in accordance with the laid down procedures. • Verify in case of LCs for import of goods, the payment to the overseas suppliers is made based on shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs. • 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. • Test the completeness of the recorded obligations. • 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. • Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities. • Examine whether the bank has given any guarantees in respect of any trade credit (buyer's credit or seller's credit) and the period

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	of guarantees is co-terminus with the period of credit reckoned from the date of shipment. • 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.
Claims Against the Bank Not Acknowledged as Debts	• Examine the relevant evidence, e.g., correspondence with lawyers/ others, claimants, workers/officers, and workmen's/officers' unions. • 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. • 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.
Liability on Account of Outstanding Forward Exchange Contracts & derivative contracts	• Verify the outstanding forward exchange contracts with the statement of outstanding forward exchange contracts generated from the bank's computerised accounting system or manual register maintained by the branch. The auditor may physically verify the underlying documents including confirmations from merchants to test the existence of such outstanding contracts. • The auditor may verify outstanding derivative contracts like options, interest rate swaps etc. with reports generated in this regard.
Guarantees Given on Behalf of Constituents	• 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 customers before issuance of guarantees as per the prescribed procedures, etc.

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	• 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 is periodically verified and reconciled with the book records, etc. • Examine the guarantee register to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not. • Check the relevant guarantee registers with the list of outstanding guarantees to obtain assurance that all outstanding guarantees are included in the amount disclosed on this behalf. • Examine that expired guarantees are not included in this head. Verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. The auditor 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".
Acceptances, Endorsements and Other Obligations	• 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. • 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. • Examine whether the bank has incurred a potential financial obligation in respect of letters of comfort and if such obligation has been cast, ensure the amount to be disclosed under contingent liability.
Other Items for which the Bank is Contingently Liable	• Determine and verify any other items under this head as required. **For example**, outstanding underwriting contracts, bills rediscounting, disputed tax demands.

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Bills for Collection	• Ensure that the bills drawn on other branches of the bank are not included in bills for collection. • Verify outward bills for collection with reference to the corresponding register maintained. • Examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection as on the date of Balance Sheet. • Examine the procedure for crediting the party on whose behalf a bill has been collected. Confirm that this procedure is in consonance with the nature of obligations of the bank in respect of bills for collection. • Examine that adequate internal controls exist 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.

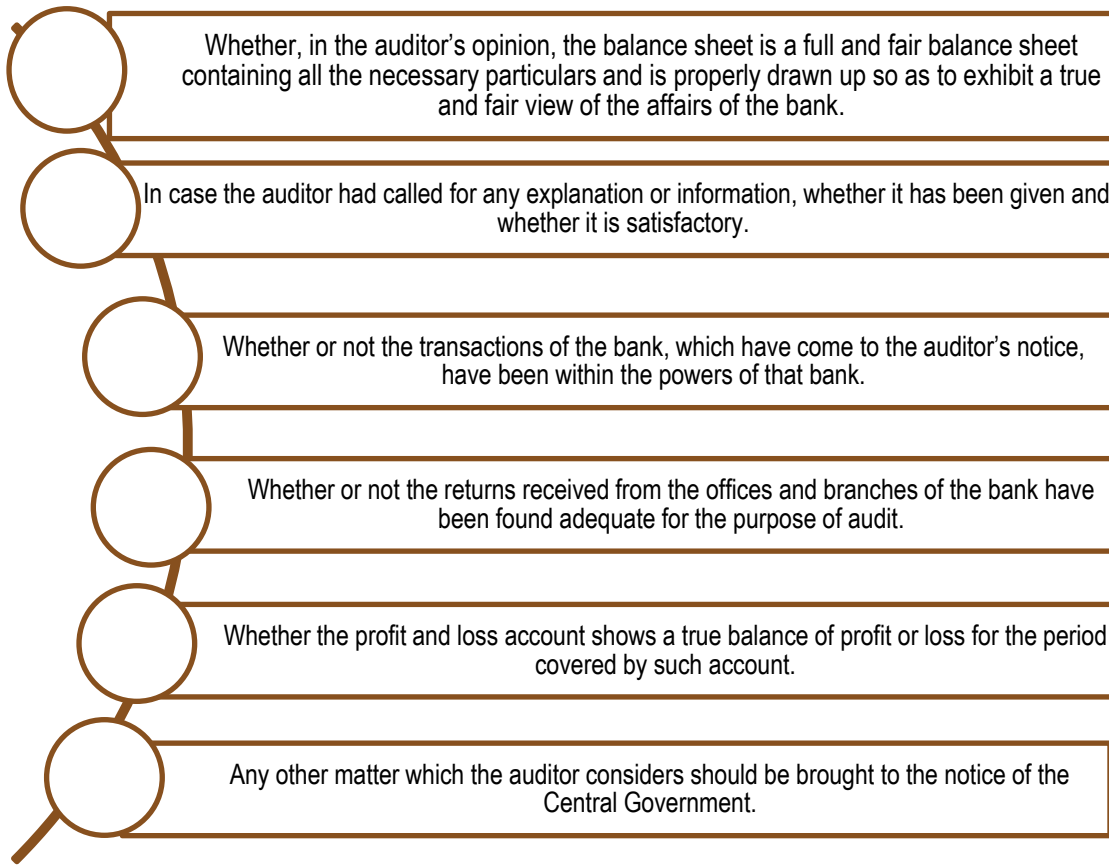
Example 5:

A large scam happened at ABC bank wherein the employees, in collusion with an unscrupulous businessman, misused the SWIFT network to transmit messages to other banks on fund requirement. While all this was done using SWIFT passwords, the transactions were never recorded in the bank's core system, thereby keeping the bank management in the dark for years. No security was obtained. It caused loss of thousands of crores to the bank. Thus, it is important to give proper importance to the recording and disclosure of contingent liabilities even though they do not form part of the main balance sheet or at the most appear on both assets as well as liabilities side with equal amounts as contra items.

9. AUDITOR'S REPORT

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which the auditor should state the following:

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9.1 Format of Audit Report

The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of SA 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report", SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", SA 710, "Comparative Information-Corresponding Figures and Comparative Financial Statements" and SA 720, The Auditor's Responsibility Relating to Other Information in Documents Containing Audited Financial Statements.

The auditor should ensure that not only the 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.

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It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in the report the matters covered by Section 143 of the Companies Act, 2013. However, it is pertinent to mention that the reporting requirements relating to the Companies (Auditor's Report) Order, 2020 is not applicable to a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949.

As per reporting requirements cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014 the auditor's report shall also include their views and comments on the following matters, namely:

(1) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(2) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(3) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

(4) (i) Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

(ii) Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

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(iii) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.

(5) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

(6) Whether the company, has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.

9.2 Long Form Audit Report

Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a long form audit report (LFAR). The long form audit report is to be given by statutory branch auditors as well as statutory central auditors. The LFAR for branch auditors is in the form of questionnaire where observations/comments have to be provided on range of matters including cash, balance with banks, investments, advances, deposits etc. These are submitted by the statutory branch auditors to statutory central auditors.

The consolidation is done at head office level and LFAR for bank is submitted by statutory central auditors to management. The LFAR, on the bank, after due examination, should be placed before the ACB of the bank indicating the action taken/proposed to be taken for rectification of the irregularities, if any, mentioned therein; and a copy of the LFAR and the relative agenda note, together with the Board's views or directions, is submitted to RBI within 60 days of submission of LFAR by statutory auditors.

9.3 Other Reporting Requirements

The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). The said circular provides details regarding liability of accounting and auditing profession including the professional conduct, non-disclosure of client information and need to report fraud.

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Auditor should also consider the compliance with provisions of Standards on Auditing.



SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", explains that the duty of confidentiality is over-ridden by statute, law or by courts. Whereas an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error according to SA 240.

Further, as per sub-section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

It must be noted that the auditor is not expected to consider each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing normal duties comes across any instance, he/she should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

9.4 Reports and certificates

Besides, as part of statutory audit process, statutory central auditor provides reports and certificates mainly consisting of following: -

- Report on adequacy and operating effectiveness of Internal financial Controls over Financial Reporting in case of banks
- Long form audit report.
- Report on compliance with SLR requirements.
- Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
- Certificate on reconciliation of securities by the bank (both on its own investment account as well as PMS Banks' account).
- Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the RBI. (investment transactions)
- Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.

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- Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention (in accordance with sec 143(12) of the Companies Act, 2013.)
- Certificate in respect of custody of unused Bank Receipt forms and their utilisation.
- Authentication of capital adequacy ratio, including disclosure requirements and other ratios reported in the notes to accounts.
- Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.
- Report on instances of adverse credit-deposit ratio in the rural areas.
- Asset liability management.
- Certificate on Corporate Governance in case of banks listed on Stock Exchange. In some banks this certification may not be got done by the central auditors.
- Certification on claim of various interest subsidies and interest subvention.

10. CONCURRENT AUDIT



Concurrent audit, as the name suggests, is an audit or verification of transactions or activities of an organisation concurrently as the transaction/activity takes place. It is not a pre-audit. The concept in this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place. It is akin to internal audit, which is a concept recognised under the Companies Act. In view of the complexities of economic activities it is now well recognised that there must be a system of someone, other than the person involved in the operations, verifying the authenticity of the transaction/activity on a regular basis, so that any deviation from the laid down procedures can be noticed in the shortest possible time and remedial action can be taken.

The concept of concurrent audit in the public as well as the private sector banks has gained acceptance in recent years. In some banks, this task has been entrusted to the internal inspection staff who are not engaged in operational activities. In other banks, this work is allotted to outside professional firms of chartered accountants. The Reserve Bank of India (RBI) has issued certain guidelines for the conduct of this audit.

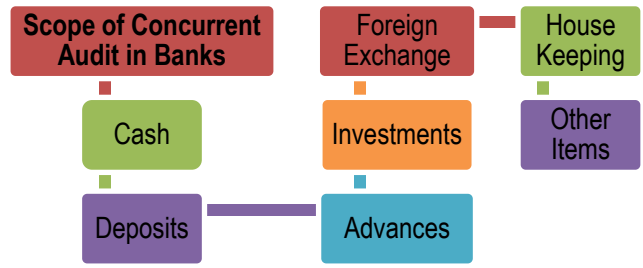
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10.1 Scope of Concurrent Audit

The detailed scope of the concurrent audit should be clearly and uniformly determined for the Bank as a whole by the Bank's Central Inspection and Audit Department in consultation with the Bank's Audit Committee of the Board of Directors (ACB). In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving lesser amounts. The detailed scope of the concurrent audit may be determined and approved by the ACB.

Further, the guidelines issued by the RBI cover all the key areas of activities of the branch which is under concurrent audit. Most banks have prepared an Audit Manual for this purpose. Broadly stated, the following areas are covered by these guidelines:

10.2 Concurrent Audit System in Commercial Banks



It hardly needs to be stressed that the concurrent audit system is to be regarded as part of a bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions at branches. It is, therefore, necessary for the bank's management to bestow serious attention to the implementation of various aspects of the system such as selection of branches/coverage of business operations, appointment of auditors, appropriate reporting procedures, follow-up/rectification processes and utilisation of the feedback from the system for appropriate and quick management decisions.

The bank should once in a year review the effectiveness of the system and take necessary measures to correct the lacunae in the implementation of the programme.

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10.3 Coverage of Business/Branches

The scope of work to be entrusted to concurrent auditors, coverage of business/branches, etc. is left to the discretion of the head of internal audit of banks with the due prior approval of the Audit Committee of the Board of Directors (ACB).

Banks may, however, ensure that risk sensitive areas identified by them as per their specific business models are covered under concurrent audit. The detailed scope of the concurrent audit may be determined and approved by the ACB.

The broad areas of coverage under concurrent audit shall be based on the identified risk of the unit and must include random transaction testing of sufficiently large sample of such transactions wherever required.

10.4 Types of Activities to be Covered

The areas that are typically covered as part of a concurrent audit and the suggested audit procedures are as follows:

Area of Focus	Suggested Audit Procedures
Cash	• Daily cash transactions with particular reference to any abnormal/ high value receipts and payments. • Proper accounting of inward and outward cash remittances. • Proper accounting of currency chest transactions, its prompt reporting to the RBI. • Expenses incurred by cash payment involving sizeable amount.
Investments	• Ensure that in respect of purchase or sale of securities the branch has acted within its delegated power having regard to its Head Office instructions. • Ensure that the securities held in the books of the branch are physically held by it. • Ensure that the branch is complying with the RBI/head Office guidelines regarding BRs, SGL forms, delivery of scrips, documentation and accounting. • Ensure that the sale or purchase transactions are done at rates beneficial to the bank.

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Deposits	• Check the transactions about deposits received and repaid. • Percentage check of interest paid on deposits may be made including calculation of interest on large deposits. • Check new accounts opened particularly current accounts. Operations in new current/SB accounts may be verified in the initial periods to see whether there are any unusual operations.
Advances	• Ensure that loans and advances have been sanctioned properly in accordance with delegated authority. • Ensure that securities and documents have been received and properly charged/ registered. • Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, recovery/ renewal of sanction limits, etc. • Verify whether there is any misutilisation of the loans and whether there are instances indicative of diversion of funds. • Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions. • Check the bank guarantees issued, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates. • Ensure proper follow-up of overdue bills of exchange. • Verify whether the classification of advances has been done as per RBI guidelines. • Verify whether the claims to DICGC and ECGC is submitted in time. • Verify that instances of exceeding delegated powers have been promptly reported to controlling/Head Office by the branch and have been confirmed or ratified at the required level.
Foreign Exchange	• Check foreign bills negotiated under letters of credit. • Check FCNR and other non-resident accounts whether the debits and credits are permissible under rules.

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	• Check whether inward/outward remittance have been properly accounted for. • Examine extension and cancellation of forward contracts for purchase and sale of foreign currency. Ensure that they are duly authorised and necessary charges have been recovered. • Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the bank. • Ensure that the overbought/oversold position maintained in different currencies is reasonable, considering the foreign exchange operations. • Ensure adherence to the guidelines issued by RBI/HO of the bank about dealing room operations. • Ensure verification/reconciliation of Nostro and Vostro account transactions/balances.
House Keeping	• Ensure that the maintenance and balancing of accounts, ledgers and registers including clean cash is proper. • Early reconciliation of entries outstanding in the inter-branch and inter-bank accounts, Suspense Account, Sundry Deposits Account, DDRR Account, Drafts Account, etc. • Ensure timely adjustment of large value entries. • Carry out a percentage check of calculations of interest, discount, commission and exchange. • Check whether debits in income account have been permitted by the competent authorities. • Check the transactions of staff accounts. • Examine the day book to verify as to how the differences in clearing have been adjusted. • Detection & prevention of revenue leakages through close examination of income and expenditure accounts. • Verify cheques returned/bills returned register and look into reasons for return of those instruments. • Checking of inward and outward remittances (DDs, MTs & TTs).

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Other items	• In case the branch has been entrusted with government business, ensure that the transactions are done in accordance with the instructions issued by Government, RBI & HQ. • Ensure that the branch gives proper compliance to the internal inspection/audit reports. • Ensure that customers' complaints are dealt with promptly. • Verify the statements, returns, statutory returns etc. submitted to RBI/ HQ.

10.5 Appointment of Concurrent Auditors and Accountability

• The option to consider whether concurrent audit should be done by bank's own staff or external auditors is left to the discretion of individual banks.
• In case the bank has engaged its own officials, they should be experienced, well trained and sufficiently senior. The staff engaged on concurrent audit must be independent of the branch where concurrent audit is to be conducted.
• ACB of the bank shall decide the maximum tenure of external concurrent auditors with the bank. Generally, tenure of external concurrent auditors with a bank shall not be more than five years on continuous basis. However, no concurrent auditor shall be allowed to continue with a branch/business unit for a period of more than three years.
• If external firms are appointed and any serious acts of omissions or commissions are noticed in their working their appointments may be cancelled and the fact may be reported to RBI & ICAI.

10.6 Remuneration of Concurrent Auditor

Terms of appointment of the external firms of Chartered Accountants for the concurrent audit and their remuneration may be fixed by ACB of banks keeping in view various factors such as coverage of areas, skill sets required, number of staff required and time to be devoted to audit.

10.7 Reporting Systems

• There should be proper reporting of the findings of the concurrent auditors. For this purpose, each bank should prepare a structured format. The major deficiencies/ aberrations noticed during audit should be highlighted in a special note and given immediately to the bank's branch/controlling offices. A quarterly review containing key features brought out during the concurrent audits should be placed before the ACB.
• There should be zone-wise reporting of the findings of the concurrent audit to ACB and an annual appraisal/report of the audit system should be placed before the ACB.

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• Before submission of the report the auditor should discuss the important issues on which he/she wishes to report with the branch manager and concerned officers. This will enable the auditor to take into consideration the opposite viewpoint and clarify any doubts.
• Minor irregularities pointed out by the concurrent auditors are to be rectified in a timely manner. Serious irregularities should be reported to the controlling offices/ Head Offices for immediate action.
• Whenever fraudulent transactions are detected, they should immediately be reported to Inspection & Audit Department (Head Office) as also the Chief Vigilance Officer as well as Branch Managers concerned (unless the branch manager is involved).
• Follow-up action on the concurrent audit reports should be given high priority by the controlling office/Inspection and Audit Department and rectification of the features done without any loss of time.

11. AUDIT COMMITTEE

Banks are required to constitute an Audit Committee of their Board in pursuance of RBI guidelines. One of the functions of this committee is to provide direction and also oversee the operations of the total audit function in the bank. The committee also has to review the internal inspection/audit function in the bank, with special emphasis on the system, its quality and effectiveness in terms of follow-up. The committee has to review the system of appointment and remuneration of concurrent auditors.

The Audit Committee is, therefore, connected with the functioning of the system of concurrent audit. The method of appointment of auditors, their remuneration and the quality of their work is to be reviewed by the Audit Committee. It is in this context that periodical meetings by the members of the audit committee with the concurrent auditors and statutory auditors help the audit committee to oversee the operations of the total audit function in the bank.

TEST YOUR UNDERSTANDING 2

You are conducting a concurrent audit of a branch of a public sector bank. It is a large branch having advances of about ₹ 500 crores including export advances of ₹ 300 crores. Some borrowers also get LCs issued from branch for importing raw diamonds from diamond hubs of Belgium. You want to be sure that there is no revenue leakage in the branch. For the time being, you are focusing upon advances. Discuss any five areas pertaining to advances of the branch which you would verify to ensure no revenue leakage.

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TEST YOUR UNDERSTANDING 3

CA Seema is appointed as stock auditor of Bhawani Rice Mills Pvt. Ltd. availing credit facilities from R.K. Puram Branch, Near Tamil Educational Society, New Delhi.

The borrower is enjoying a cash credit limit of ₹ 12 crore from branch against security of paid stocks and debtors up to 90 days against margin of 25%. She proceeds to visit the premises of Bhawani Rice Mills Pvt. Ltd. located on outskirts of Delhi. She verifies books of accounts and stock records of the company and also test checks quantity of paddy and rice of 20000 quintals and 8000 bags lying in premises of the company. The drawing power of ₹ 12.05 crore is computed in stock audit report and report stands submitted to bank.

After about a week, regular internal inspector appointed by Inspection department of bank also happened to visit premises of the borrower and found that rice contained in about 5000 bags included in stocks having approx. value of ₹ 1.50 crore was fungus ridden. The company has been holding this stock for the last 15 months.

How do you view the above situation? Discuss.

Key Takeaways

- Special audit considerations arise in audit of banks due to particular nature of risks associated with transactions undertaken, scale of banking operations, extensive dependence on IT to process transactions, effect of statutory and regulatory requirements and continuous roll out of new products and services.
- Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.
- It is pertinent to state that preparation of balance sheet of a bank usually involves preparation of standalone financial statements and consolidated financial statements. Preparation of Standalone financial statements involves consolidation of branch accounts and incorporation of various verticals/departments of bank in case of a nationalized bank/public sector bank. The detailed procedures in this regard may vary from bank to bank. In the case of private banks, the processes of accounting are centralized and there is no concept of mandatory branch audit in accordance with RBI guidelines.

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- Most banks, especially those in nationalised banks or public sector, appoint four or more (depending upon their size and Board decision, as per RBI guidelines) firms of chartered accountants to act jointly as statutory central auditors (SCAs)
- As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the concerned bank acting through its Board of Directors. In either case, approval of the Reserve Bank is required before the appointment is made.
- The technological developments have brought new challenges for auditors as audit is required to be conducted through the system.
- It is responsibility of statutory central auditors to obtain understanding of IT environment and various controls put in place by management and evaluate whether controls are operating effectively.
- Banks are required to implement and maintain a system of internal controls for mitigating risks, maintain good governance and to meet the regulatory requirements. Areas of focus in respect of internal control include cash, clearings, bills for collection, bills purchased, loans and advances, inter-branch accounts and credit card operations. Audit procedures have to be designed for verification of items of assets and liabilities taking into account special considerations relevant to banks.
- Advances generally constitute a major part of the assets of the bank. The audit of advances requires major attention from the auditors. There exists elaborate and detailed control system & procedure in banks pertaining to appraisal, sanctioning, documentation, disbursal, review, monitoring and supervision of advances. Audit approach of advances should encompass designing appropriate audit procedures to obtain audit evidence in all these areas.
- Concurrent audit is an audit or verification of transactions or activities of an organisation concurrently as the transaction/activity takes place. The concept in this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place.
- A concurrent audit system is to be regarded as part of a bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions at branches. The important areas to be covered in concurrent audit include cash, investments, deposits, advances, foreign exchange and housekeeping etc.

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- Banks are required to constitute an Audit Committee of their Board in pursuance of RBI guidelines. One of the functions of this committee is to provide direction and also oversee the operations of the total audit function in the bank. The committee also has to review the internal inspection/audit function in the bank, with special emphasis on the system, its quality and effectiveness in terms of follow-up. The committee has to review the system of appointment and remuneration of concurrent auditors.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. Your Audit Manager informed you that the bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year. Comment.*

2. *As statutory central auditors of a Nationalized bank, what special points are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements?*

3. *Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines.*

4. *In course of audit of Good Samaritan Bank as at 31st March, 24 you observed the following:*

   (a) *In a particular account there was no recovery in the past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government?*

   (b) *The bank's advance portfolio comprised of significant loans against Life Insurance Policies. Write a suitable audit program to verify these advances.*

5. *Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The bank is a consortium member of Cash Credit Facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest the credits in X Ltd's account are to the tune of ₹ 1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing. The Bank*

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follows financial year as accounting year. Advise your views on the issue which were brought to your notice by your Audit Manager.

6. *You have been appointed as an auditor of LCO Bank, a nationalized bank. LCO Bank also deals in providing credit card facilities to its account holder. The bank is aware of the fact that there should be strict control over storage and issue of credit cards. How will you evaluate the Internal Control System in the area of Credit Card operations of a Bank?*

7. *You have been appointed as Concurrent Auditor of a nationalized bank branch. The main business at the branch is dealing in foreign exchange. Suggest the main areas of coverage with regard to foreign exchange transactions of the said branch under concurrent audit.*

8. *While auditing FAIR Bank, you observed that a lump sum amount has been disclosed as contingent liability collectively. You are, therefore, requested by the management to guide them about the disclosure requirement of Contingent Liabilities for Banks. Kindly guide.*

9. *ABC Chartered Accountants have been appointed as concurrent auditors for the branches of Effective Bank Ltd. for the year 2023-24. You are part of the audit team for the Agra branch of the bank and have been instructed by your senior to verify the advances of the audit period. You are required to guide your assistant about the areas to be taken care of while doing verification during the concurrent audit.*

10. *In the course of audit of Skip Bank Ltd., you found that the Bank had sold certain of its non-performing assets. Draft the points of audit check that are very relevant to this area of checking.*

11. *Banks, because of certain characteristics, are distinguished from other commercial enterprises and hence it needs special audit consideration. As an auditor of a bank, specify the various peculiarities which may necessitate special audit consideration to be taken care by you?*

12. *ABC Bank had sanctioned credit limits of ₹ 100 lakh to M/s Volkart Ltd on 1st September 2021. The renewal of limits was due on 1st September 2023. While doing the statutory branch audit for the year ended 31st March 2024, you find that the renewal has not been done even though 180 days are over. The bank says that the renewal process has been initiated on time and most of the documents are received. The account is operated regularly and is in order; balance is maintained within drawing power. It also shows a letter from Volkart stating that due to a sudden death of their auditor, a new auditor had to be appointed. Procedure for appointment took some time and the new auditor was doing the audit all over again. The limit was not renewed till 31st March 2024. However, the audited financials are received on 10th*

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April 2024 and the renewal letter was issued immediately. Your assistant is insisting that the account must be classified as NPA since the limit was not renewed as on 31st March 2024. What is your opinion?

13. *You are auditing a small bank branch with staff strength of the manager, cashier and three other staff S1, S2 and S3. Among allocation of work for other areas, S1, who is a peon also opens all the mail and forwards it to the concerned person. He does not have a signature book so as to check the signatures on important communications. S2 has possession of all bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.). He maintains a record meticulously which you have test checked also. However, no one among staff regularly checks that. You* are informed that being a small branch with shortage of manpower, it is not possible to always check the work and records. Give your comments.

14. ***NRF Bank Ltd. is suffering from huge number of NPAs. During the month of April 2024, the management of the bank decided to sell some of its NPAs. Bank is doing this exercise for the first time. The management has selected following NPA accounts for sale:***

Name	*NPA since F.Y.*	*Amount (₹ In Lakh)*
Fin Pvt. Ltd.	*2020-21*	*36.55*
Dairy Works	*2022-23*	*55.24*
Book Store	*2019-20*	*29.85*
Fancy Corp.	*2018-19*	*61.42*
RSM and Associates	*2021-22*	*19.25*

Being internal auditor of the bank, you are required to scrutinize the proposal made by the branch and help them by providing specific points to be considered.

15. ***PDSJ & Associates are Statutory Auditors of a scheduled Commercial Bank for the year 2023-24. While evaluating internal control over advances, it came to their notice that classification of term loan borrower accounts into SMA as well as NPA is done in the system on the following lines:***

- ***In case full dues are not received on a particular due date, a borrower account is immediately considered as overdue on the very next day. For example, if due***

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date of loan account is 31st March, 2023 and dues are not received on 31st March, 2023, it shall be considered as overdue on 1st April, 2023.

- *If it continues to remain overdue, then account is tagged as SMA-1 on 1st May, 2023.*
- *If it continues to remain overdue further, then account is tagged as SMA-2 on 31st May, 2023.*
- *If it continues to remain overdue even after being tagged as SMA-2, it is classified as NPA on 30th June, 2023.*

Evaluate above control designed by bank in the system for the purpose of exercising control over such advances in compliance with regulatory guidelines.

16. *RML & Associates are one of the joint auditors of IND Bank for the year 2023-24. While auditing IND Bank, they are analysing industry data relating to NPAs in select public sector banks as part of risk assessment procedures:*

Name of Bank	Gross NPAs (in ₹ crore)	Net NPAs (in ₹ crore)	Ratio of Net NPAs to Net advances
BIC Bank	55,000	13,000	1.72%
ABD Bank	45,000	10,000	2.34%
RIN Bank	55,000	18,000	2.65%
IND Bank	28,000	6,500	3.97%
CRB Bank	35,000	8,800	2.27%

In the above context, what do you understand by "Gross NPAs" and "Net NPAs" as on reporting date in the context of financial statements of a Bank? As an auditor of IND Bank, what inference would you draw by comparing the "Ratio of net NPAs to net advances" with other public sector banks?

17. *CA J is the statutory auditor of the branch of a nationalized bank. During the audit, he is also focusing upon verification of Current Accounts & Savings Accounts (CASA) maintained at the branch. Suggest a few audit procedures he should follow.*

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Answers to Test your understanding

1. An account becomes NPA when it ceases to generate income for the bank. In the given situation, all the five accounts examined are operating satisfactorily. There is no reason for suggesting changes in their classification.

The matter of incompletely filling up loan applications and lack for record for assessment of enhanced working capital requirements shows that internal control over advances in branch is not proper. The above said situation shows deficiencies in "credit appraisal" at branch level. Such deficiencies need to be highlighted by the auditor in LFAR.

2. **The areas of advances which need to be verified are as under: -**

i. Interest rates fed in the system need to be verified with respect to corresponding sanction letters. It would help ensure that correct rate of interest is fed into the system, and interest is applied properly at stipulated intervals on advances.

ii. Processing fees in respect of freshly sanctioned advances and renewed limits need to be levied in accordance with bank guidelines and these need to be verified. Any revision in processing fees from time to time has to be given effect to in accordance with circulars/manual of bank.

iii. Sanction of cash credit limits is generally accompanied with stipulation to submit stock statements. Non-submission of stock statements can involve levying penal interest. Verification of this aspect is required.

iv. Verification of overdue interest on export bills purchased and packing credit facilities for overdue period.

v. Verification of charges/commission in respect of letters of credit issued in accordance with Bank's circulars/manual.

3. The above situation reflects that the professional work of stock audit was not performed diligently by stock auditor. It is one of the important responsibilities of stock auditor to verify condition of stocks. The auditor's role is not limited to verifying physical quantities only.

In a given case, she should have got opened rice bags on test check basis. In the process, she could have come to know about fungus ridden condition of rice. The value of such rice should have been excluded while arriving at value of stocks for purpose of computation of drawing power. It shows that she has failed to perform her work diligently and drawing power calculated in the report submitted to bank is not proper.

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Answers to Theoretical Questions

1. Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS 9. In this case the dividends have been declared after the financial year end. Therefore, the recognition of income by the bank on accrual basis is not in order.

In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the central government or a State government.

2. Refer Para no 6.

3. Refer Para no. 10.1

4. **(a)** **Government Guaranteed Advance:** If a government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not be taken to income unless interest is realized. However, for the purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked.

Since the bank has not invoked the guarantee, the question of repudiation does not arise. Hence the bank is correct to the extent of not applying the NPA norms for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the income to the extent not recovered should be reversed.

The situation would be different if the advance is guaranteed by the State Government because this exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days.

In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

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(b) The Audit Programme to Verify Advances against Life Insurance Policies is as under-

(i) The auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer.

(ii) The auditor should also examine whether premium has been paid on the policies and whether they are in force.

(iii) Certificate regarding surrender value obtained from the insurer should be examined.

(iv) The auditor should particularly see that if such surrender value is subject to payment of certain premium, the amount of such premium has been deducted from the surrender value.

5. The bank is a consortium member of cash credit facilities of ₹ 50 crores to X Ltd. Bank's own shares are ₹ 10 crores only. During the last two quarters, against a debit of ₹ 1.75 crores towards interest, the credits in X Ltd.'s account are to the tune of ₹ 1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.

6. Refer Para 5.

7. Refer Para 10.4.

8. Refer Para 8 - Part (VI).

9. Refer Para 7 sub heading III.

10. Refer Para 7 sub heading III.

11. Refer Para 1.

12. As per Guidelines of Reserve Bank of India the account should be classified as NPA if renewal is not done in 180 days. However, in the present case, operations in the account are excellent. The bank has shown a letter from that company that due to certain reasons the audited financial statements are delayed. Further, the limit has been renewed before signing the audit report.

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Thus, even if the sanction was issued after the balance sheet date, it relates to the position as on the balance sheet date. Therefore, it is an adjusting event under AS 4, Contingencies and Events Occurring After the Balance Sheet Date. It is also a matter of substance over form.

The auditor would consider classifying the account as a standard asset.

13. Banks are required to implement and maintain a system of internal controls for mitigating risks, maintain good governance and to meet the regulatory requirements. Given below are examples of internal controls that are violated in the given situation:

In the instant case, S1 who is a peon opens all the mail and forwards it to the concerned person. Further, he does not have a signature book so as to check the signatures on important communications is not in accordance with implementation and maintenance of general internal control. As the mail should be opened by a responsible officer. Signatures on all the letters and advices received from other branches of the bank or its correspondence should be checked by an officer with the signature book.

All bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.) should be kept in the possession of an officer, and another responsible officer should verify the issuance and stock of such stationery. In the given case, S2 has possession of all bank forms (e.g. cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.). He maintains a record meticulously which were also verified on test check basis.

Further, contention of bank that being a small branch with shortage of manpower they are not able to check the work and records on regular basis, is not tenable as such lapses in internal control pose risk of fraud.

The auditor should report the same in his report accordingly.

14. In case of Sale of NPA by Bank, the auditor should examine that:

- ***The policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers including non- performing financial assets that may be sold, norms or such sale, valuation procedure and accounting policy.***
- ***Only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.***
- ***The assets have been sold "without recourse' only i.e., the entire credit risk***

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associated with the non-performing asset should be transferred to the purchasing bank.

- *Subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.*
- *The NPA has been sold at cash basis only. Under no circumstances, NPA can be sold to another bank at a contingent price. The entire sale consideration has to be received on upfront basis.*
- *The bank has not purchased an NPA which it had originally sold.*
- *On the sale of the NPA, the same has been removed from the books of the account of selling bank on transfer.*
- *If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year.*
- *If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/ loss on account of sale of other non-performing financial assets.*

In the given situation, management of NRF Bank Ltd. is considering to sell following NPAs, during the month of April, 2024:

Name	*NPA since F.Y.*	*Amount (₹ in lakh)*
Fin Pvt. Ltd.	*2020-21*	*36.55*
Dairy Works	*2022-23*	*55.24*
Book Store	*2019-20*	*29.85*
Fancy Corp.	*2018-19*	*61.42*
RSM and Associates	*2021-22*	*19.25*

In view of above-mentioned conditions, the auditor is required to ensure that only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.

Considering the facts given in the question all the NPAs, except for Dairy Works, are prior to April 2021 i.e., 2 years prior to April 2024. In view of the above provisions, management of NRF Bank Ltd. can sell all the NPAs except for NPA of 55.24 lakh rupees of Dairy Works as it has remained NPA in the books of the banks less than 2-year duration.

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15. *The design of the above control instituted by the bank in its system is not in accordance with the regulatory guidelines. Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date which is fixed by the bank, the borrower accounts are flagged as overdue by the banks as part of their day-end processes for the due date.*

Classification of borrower accounts as SMA as well as NPA is done as part of day-end process for the relevant date. SMA or NPA classification date is the calendar date for which the day end process is run. In other words, the date of SMA/NPA reflects the asset classification status of an account at the day-end of that calendar date.

In the given situation, the due date of a loan account is March 31, 2024, and full dues are not received by the bank before it runs the day-end process for this date, the date of overdue shall be March 31, 2024, and not 1st April, 2024.

If it continues to remain overdue, then this account shall get tagged as SMA-1 upon running day-end process on April 30, 2024 [i.e. upon completion of 30 days of being continuously overdue]. Accordingly, the date of SMA-1 classification for that account shall be April 30, 2024.

Similarly, if the account continues to remain overdue, it shall get tagged as SMA-2 upon running day-end process on May 30, 2024, and if continues to remain overdue further, it shall get classified as NPA upon running day-end process on June 29, 2024.

16. *Gross NPAs represent opening balances of NPAs as increased by fresh NPAs during the year and reduced by upgradations, recoveries and write-offs during the year.*

Net NPAs are arrived at after deducting amounts on account of the total provision held against NPAs, balance in the interest suspense account to park accrued interest on NPAs and certain other adjustments.

The Net NPAs to Net advances ratio is higher in the case of IND Bank as compared to other public sector banks. This indicates that there is a risk that the bank may not have made the required provisions in accordance with RBI guidelines. A higher net NPAs to Net advances ratio indicates the probability and risk of under-provisioning. Keeping in view of the above, audit procedures have to be tailored towards the examination and verification of this crucial area.

17. *Refer Para 8.2.*

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UNIT 2 – SPECIAL FEATURES OF AUDIT OF NON-BANKING FINANCIAL COMPANIES (NBFCs)

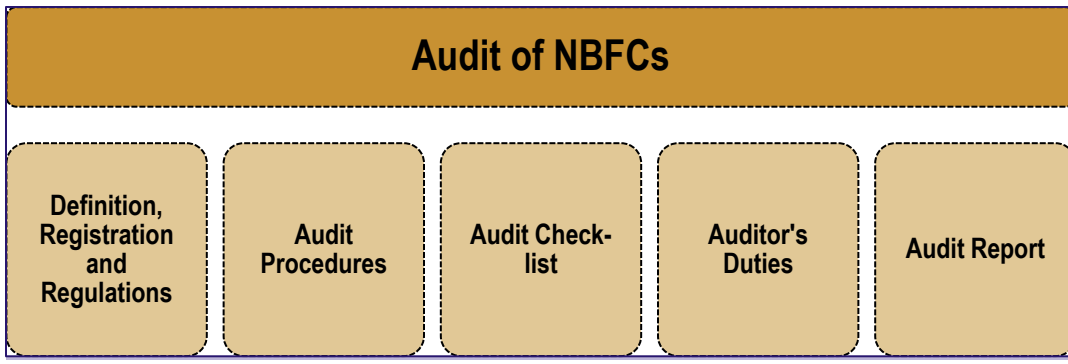
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the definition, regulations and types of Non-Banking Finance Companies (NBFCs).
- Difference between Banks and NBFCs.
- Gain the knowledge of the prudential norms- Capital Requirements, Income Recognition, and Provisioning requirements.
- Learn the audit procedures and Audit Checklist for NBFCs.
- Apply & analyse the above-mentioned concepts in moderately complex scenarios.

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UNIT OVERVIEW



CA Sachet is appointed as the statutory auditor of an NBFC. How important are NBFCs in financial system of a large and diverse country as India? Part of the country's financial services sector, NBFCs cater to variety of customers in rural and urban areas thus promoting inclusive growth. Such entities have become an important source of credit for those segments of society which cannot meet strict requirements of banks for lending purposes. They are popular in the areas of housing finance, financing for commercial vehicles, microfinance industry, MSME sector and in other areas. And how does an NBFC differ from a bank? Although NBFCs lend like banks, they cannot accept demand deposits and are not part of payment and settlement system like banks.

As part of understanding NBFCs, Sachet found such entities to be strictly regulated. They have to obtain certificate of registration to commence business of non-banking financial institution. There are RBI directions and norms on acceptance of public deposits, capital adequacy, risk exposure and other measures to monitor financial solvency and reporting.

NBFCs are also subject to regulatory norms for asset classification, provisioning and income recognition as per directions of RBI. NBFCs having applicability of Ind AS are also required to consider principles of relevant Ind AS in the preparation of financial statements. In fact, financial statements of an NFBC having applicability of Ind-AS are required to be prepared in accordance with Division III of Schedule III of the Companies Act, 2013. Audit approach to an NBFC has to take into account all such issues.

He was also checking for regulatory updates in NBFC sector as part of understanding it. He became aware of applicability of *"scale based"* regulations defining NBFCs on basis of their size, activity and perceived riskiness into four layers i.e., base layer, middle layer, upper layer and top layer.

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Whereas upper layer comprises of NBFCs specifically identified by RBI for enhanced regulatory requirement, top layer would ideally remain empty unless RBI is of the opinion that there is substantial increase in potential systemic risk from specific NBFCs in upper layer. Not in the upper layer published by RBI, he was trying to confirm classification of this very auditee company in accordance with such regulations.

Sensing that there was increased responsibility of an auditor of NBFC in view of various RBI directions, he tweaked his audit approach accordingly. Not only auditor of NBFC is required to report to shareholders, he is also responsible for making an additional report to the Board of Directors of the company on certain specified matters in accordance with RBI directions.

1. INTRODUCTION

Non-Banking Finance Company sector has evolved considerably in terms of its size, operations, technological sophistication, and entry into new areas of financial services and products. NBFCs are now deeply interconnected with the entities in the financial sector, on both sides of their balance sheets. Being financial entities, they are exposed to risks arising out of counterparty failures, funding and asset concentration, interest rate movement and risks pertaining to liquidity and solvency, as any other financial sector player. At the same time there are segments within the sector that do not pose any significant risks to the system.



Fig. : NBFCs*



Fig.: Audit of NBFCs*

** Source: Techno Legal Journalists*
** Source: Inventicon*

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Definition of NBFC: 45 I(f) of Reserve Bank of India (Amendment) Act, 1997 defines a non-banking financial company as:

(i) A financial institution which is a company;

(ii) A non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) Such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;"



Fig. : What is NBFC*

Further, in order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as NBFC when a company's financial assets constitute more than 50 per cent of the total assets (netted off by

** Source: Slideshare*

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intangible assets) and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by RBI.

Registration and Regulation of NBFC:

Under Section 45–IA of the Reserve Bank of India Act, 1934, no non-banking financial company is allowed to commence or carry on the business of a non-banking financial institution without

- obtaining a certificate of registration issued by the Reserve Bank of India and
- having the net owned fund of twenty-five lakh rupees or such other amount, not exceeding hundred crore rupees, as the Bank may, by notification in the Official Gazette, specify.
- Provided that the Bank may notify different amount of net owned fund for different categories of non-banking financial companies.

RBI has notified different amounts of net owned fund for different categories of NBFCs including rupees 2 crore for certain categories of NBFCs

(For certain categories companies currently applying for registration as an NBFC, the minimum net owned fund requirement is INR 10 Crore (previously it was INR 2 Crore) (Minimum NOF amount may be higher depending on specific type of NBFC).

RBI has prescribed a timeline to meet NOF amount of INR 10 Crore in a phased manner for certain categories of existing NBFCs by 31st March 2027. However, for NBFC-P2P, NBFC-AA, and NBFCs with no public funds and no customer interface, the NOF shall continue to be INR 2 Crore. ***For NBFC-IFC and IDFNBFC, the NOF shall be ₹300 crore.***

A company incorporated under the Companies Act and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to the Reserve Bank of India in prescribed form along with necessary documents for registration. The RBI issues the Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

The Reserve Bank of India has issued directions to non-banking financial companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs.

Directions were also issued to auditors to report non-compliance with the RBI Act and the Regulations to the RBI, Board of Directors and shareholders. RBI has also issued the Fair Practices Code to be adopted by all NBFCs while doing lending business. The guidelines inter alia, covered general principles on adequate disclosures on the terms and conditions of a loan and also adopting a non-coercive recovery method.

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Types of NBFCs- Compliance and Regulatory Perspective:

In terms of the Section 45-I(f) read with Section 45-I (c) of the RBI Act, 1934, as amended in 1997, non-banking financial company (NBFC) is a company registered under the Companies Act,1956/2013, engaged in the business of loans and advances, acquisition of shares/stocks/bonds/ debentures/ securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

NBFCs mandated to register under RBI

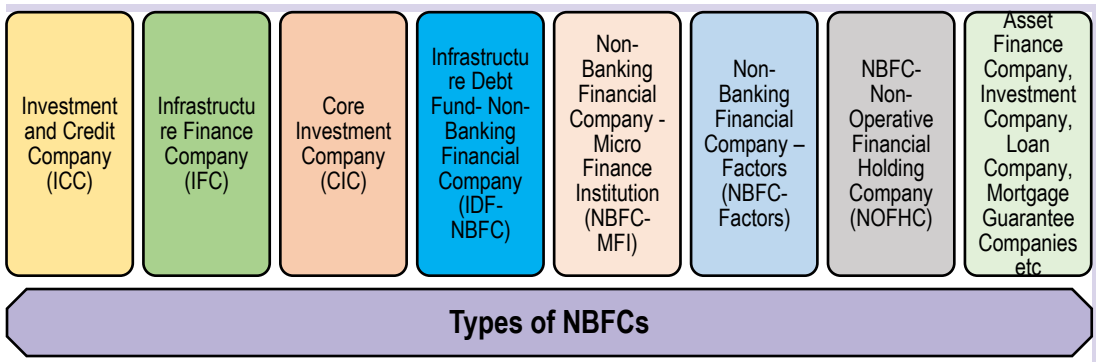
NBFCs registered with RBI are categorized as follows:

(a) in terms deposit acceptance or otherwise into Deposit and Non-Deposit accepting NBFCs;

(b) non deposit taking NBFCs by their size into Base Layer, Middle Layer, Upper Layer and Top Layer; and

(c) by the kind of activities, they conduct.

Within the categorization mentioned in (c) above, (i.e. by the kind of activity they conduct) the different types of NBFCs are as follows:



All NBFCs are either deposit taking or non-deposit taking. If they are non-deposit taking, ND is suffixed to their name (NBFC-ND).

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A. Companies exempted from registration under RBI

Companies that do financial business but are regulated by other regulators are given specific exemption by the Reserve Bank from its regulatory requirements for avoiding duality of regulation. Following NBFCs have been exempted from the requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions.

➢ Housing Finance Institutions (regulated by National Housing Bank);
➢ Merchant Banking Companies (regulated by Securities and Exchange Board of India);
➢ Stock Exchanges (regulated by Securities and Exchange Board of India);
➢ Companies engaged in the business of stock-broking/sub-broking (regulated by Securities and Exchange Board of India);
➢ Venture Capital Fund Companies (regulated by Securities and Exchange Board of India);
➢ Nidhi Companies (regulated by Ministry of Corporate Affairs, Government of India);
➢ Insurance companies (regulated by Insurance Regulatory and Development Authority); and
➢ Chit Companies (as defined in clause (b) of section 2 of the Chit Funds Act, 1982 (Act 40 of 1982)).
➢ Specified Micro Finance Companies.
➢ Securitisation and Reconstruction Companies.
➢ Mutual Benefit Companies.
➢ Core Investment Companies.
➢ Alternative Investment Fund (AIF) Companies.

Core Investment Companies with asset size of less than ₹ 100 crore, and those with asset size of ₹ 100 crore and above but not accessing public funds are exempted from registration with the RBI.

Pursuant to the announcement of *Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs* on 22 October 2021 to be effective from 01 October 2022, RBI has revised different facets of existing NBFC Classification and regulation like Capital Requirements, Governance Standards, Prudential Regulations, etc. based on four layers that are defined based on their size, activity, and perceived riskiness.

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These four layers are NBFC – Base Layer (NBFC-BL), then NBFC- Middle Layer (NBFC-ML), NBFC Upper Layer (NBFC-UL) and lastly NBFC – Top Layer (NBFC-TL).

The Top layer is ideally expected to be empty and will be filled by RBI based on required need.

Details of NBFCs populating the various layers is mentioned below:

Base Layer

The Base Layer shall comprise of (a) non-deposit taking NBFCs below the asset size of ₹1000 crore and (b) NBFCs undertaking the following activities- (i) NBFC-Peer to Peer Lending Platform (NBFC-P2P), (ii) NBFC-Account Aggregator (NBFC-AA), (iii) Non-Operative Financial Holding Company (NOFHC) and (iv) NBFCs not availing public funds and not having any customer interface.

Middle Layer

The Middle Layer shall consist of (a) all deposit taking NBFCs (NBFC-Ds), irrespective of asset size, (b) non-deposit taking NBFCs with asset size of ₹1000 crore and above and (c) NBFCs undertaking the following activities (i) Standalone Primary Dealers (SPDs), (ii) Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs), (iii) Core Investment Companies (CICs), (iv) Housing Finance Companies (HFCs) and (v) Infrastructure Finance Companies (NBFC-IFCs).

Upper Layer

The Upper Layer shall comprise of those NBFCs which are specifically identified by the Reserve Bank as warranting enhanced regulatory requirement based on a set of parameters and scoring methodology as provided **(for detailed circular scan the QR code given in Key Takeaways)**. The top ten eligible NBFCs in terms of their asset size shall always reside in the upper layer, irrespective of any other factor.

Top Layer

The Top Layer will ideally remain empty. This layer can get populated if the Reserve Bank is of the opinion that there is a substantial increase in the potential systemic risk from specific NBFCs in the Upper Layer. Such NBFCs shall move to the Top Layer from the Upper Layer.

Categorisation of NBFCs carrying out specific activity

As the regulatory structure envisages scale based as well as activity-based regulation, the following prescriptions shall apply in respect of the NBFCs

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(a) NBFC-P2P, NBFC-AA, NOFHC and NBFCs without public funds and customer interface will always remain in the Base Layer of the regulatory structure.

(b) NBFC-D, CIC, IFC and HFC will be included in Middle Layer or the Upper Layer (and not in the Base layer), as the case may be. SPD and IDF-NBFC will always remain in the Middle Layer.

(c) The remaining NBFCs, viz., Investment and Credit Companies (NBFC-ICC), Micro Finance Institution (NBFC-MFI), NBFC-Factors and Mortgage Guarantee Companies (NBFC-MGC) could lie in any of the layers of the regulatory structure depending on the parameters of the scale based regulatory framework.

(d) Government owned NBFCs shall be placed in the Base Layer or Middle Layer, as the case may be. They will not be placed in the Upper Layer till further notice.

References to NBFC-ND, NBFC-ND-SI & NBFC-D - From October 01, 2022:

All references to NBFC-ND shall mean NBFC-BL and all references to NBFC-D and NBFC-NDSI shall mean NBFC-ML or NBFC-UL, as the case may be. However, existing NBFC-ND-SIs having asset size between ₹ 500 Crore and below ₹ 1000 Crore (except those necessarily featuring in Middle Layer) will be known as NBFC- BL.

The following glide path is provided for the existing NBFCs, viz., NBFC-ICC, NBFC-MFI5 and NBFC-Factor to achieve the NOF of ₹ 10 crore:

NBFCs	*Current NOF*	*By March 31, 2025*	*By March 31, 2027*
NBFC-ICC	*₹ 2 crore*	*₹ 5 crore*	*₹ 10 crore*
NBFC-MFI	*₹ 5 crore (₹ 2 crore in NE Region)*	*₹ 7 crore (₹ 5 crore in NE Region)*	*₹ 10 crore*
NBFC-Factor	*₹ 5 crore*	*₹ 7 crore*	*₹ 10 crore*

(for detailed circular scan the QR code given in Key Takeaways).

2. DIFFERENCE BETWEEN BANKS AND NBFCS

NBFCs lend and make investments and hence, their activities are akin to that of banks, however, there are a few differences between the two as given below:

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i.	NBFC cannot accept demand deposits, however some NBFCs can accept Term Deposits;
ii.	NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;
iii.	The deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation (DICGC) is not available to depositors of NBFCs, unlike in case of banks.
iv.	No Minimum Exposure to Priority Sector required by NBFCs.



3. PRUDENTIAL NORMS

3.1 Capital Requirements

Every applicable NBFC as defined in the Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023 shall maintain a minimum capital ratio consisting of Tier 1 and Tier 2 capital which shall not be less than 15 percent of its aggregate risk weighted assets on balance sheet and of risk adjusted value of off-balance sheet items. Tier 1 capital in respect of NBFC (except NBFC-MFI and NBFC primarily engaged in lending against gold jewellery, at any point of time, shall not be less than 10 percent.

"Tier 1 capital" for NBFCs (except NBFCs-BL) is the sum of

(i) ***Owned fund as reduced by investment in shares of other NBFCs and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten percent of the owned fund; and***

(ii) ***Perpetual debt instruments issued by a non-deposit taking NBFCs in each year to the extent it does not exceed 15 percent of the aggregate Tier 1 capital of such company as on March 31 of the previous accounting year.***

Note – NBFCs-BL are not eligible to include perpetual debt instruments in their Tier 1 capital.

Tier I capital for NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 percent of more of their financial assets) shall maintain a minimum Tier 1 capital of 12 percent of aggregate risk weighted assets of on-balance sheet and of risk adjusted value of off-balance sheet items.

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"Tier 2 capital" for NBFCs (except NBFCs-BL) is the sum of

(i) Preference shares other than those which are compulsorily convertible into equity;

(ii) Revaluation reserves at discounted rate of 55 percent;

(iii) General provisions (including that for Standard Assets) and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets;

(iv) Hybrid debt capital instruments;

(v) Subordinated debt; and

(vi) Perpetual debt instruments issued by a non-deposit taking NBFC which is in excess of what qualifies for Tier 1 capital;

to the extent the aggregate does not exceed Tier 1 capital.

Note – NBFCs-BL are not eligible to include perpetual debt instruments in their Tier 2 capital.

Note for Students : [Students may refer detailed Guidelines given in the Appendix].

Explanations: In these Directions, degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. ***For example, percentage weights assigned to Fixed Assets is 100, Cash & Bank Balances is 0, etc.*** Hence, the value of each asset / item requires to be multiplied by the relevant risk weights to arrive at risk adjusted value of assets. The aggregate shall be taken into account for reckoning the minimum capital ratio. **The risk weighted asset shall be calculated as the weighted aggregate of funded items as detailed hereunder:**

S. No.	Weighted risk assets - On-Balance Sheet items	Percentage weight
(i)	Cash and bank balances including fixed deposits and certificates of deposits with banks	0
(ii)	**Investments:**	
	(a) Approved securities [Except at (c) below]	0
	(b) Bonds of public sector banks	20
	(c) Fixed deposits/certificates of deposits/bonds of public financial institutions	100
		100

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	(d) Shares of all companies and debentures / bonds/ commercial papers of all companies and units of all mutual funds	
	(e) All assets covering PPP and post commercial operations date (COD) infrastructure projects in existence over a year of commercial operation	50
(iii)	**Current assets/*Other Financial Assets*:**	
	(a) Stock on hire (net book value)	100
	(b) Intercorporate loans/deposits	100
	(c) Loans and advances fully secured against deposits held	0
	(d) Loans to staff	0
	(e) Other secured loans and advances considered good	100
	(i) Consumer credit exposure (outstanding as well as new) categorised as retail loans, excluding housing loans, educational loans, vehicle loans, loans against gold jewellery and microfinance/SHG loans	***125***
	(ii) Credit Card Receivables	***125***
	[Except at (vi) below]	
	(f) Bills purchased/discounted	100
	(g) Others (To be specified)	100
(iv)	**Fixed Assets (net of depreciation):**	
	(a) Assets leased out (net book value)	100
	(b) Premises	100
	(c) Furniture & Fixture	100
(v)	**Other assets:**	
	(a) Income tax deducted at source (net of provision)	0
	(b) Advance tax paid (net of provision)	0
	(c) Interest due on Government securities	0
	(d) Others (to be specified)	100

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(vi)	**Domestic Sovereign:**	
	(a) Fund based claims on the Central Government	0
	(b) Direct loan / credit / overdraft exposure and investment in State Government securities	0
	(c) Central Government guaranteed claims	0
	(d) State Government guaranteed claims, which have not remained in default / which are in default for a period not more than 90 days 20	20
	(e) State Government guaranteed claims, which have remained in default for a period of more than 90 days	100

3.2 Income Recognition

The income recognition shall be based on recognised accounting principles. Income including interest/ discount/ hire charges/ lease rentals or any other charges on NPA shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.

Asset classification: The asset classification norms as given below shall apply to every applicable NBFC (except NBFC-MFIs):

(1) Every NBFC shall, after taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease/hire purchase assets, loans and advances and any other forms of credit into the following classes, namely:

(i) Standard assets;

(ii) Sub-standard assets;

(iii) Doubtful assets; and

(iv) Loss assets.

(2) The class of assets referred to above shall not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the upgradation.

(3) (i) Standard asset shall mean the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem or carry more than normal risk attached to the business.

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(ii) "Sub-Standard Asset" shall mean:

(a) an asset which has been classified as non-performing asset for a period not exceeding 18 months except for NBFC-ML and above);

Further, an asset which has been classified as non-performing asset for a period not exceeding 12 months for NBFC-ML and above) will be considered as Sub-Standard Asset;

(b) an asset, where the terms of the agreement regarding interest and/or principal have been renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms.

Provided that the classification of infrastructure loan as a sub-standard asset shall be in accordance with the provisions of paragraph 17 of these Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023;

(iii) Doubtful Asset shall mean:

(a) a term loan, or

(b) a lease asset, or

(c) a hire purchase asset, or

(d) any other asset,

- ***which remains a sub-standard asset for a period 'exceeding 18 months' except for NBFC-ML and above.***
- ***which remains a sub-standard asset for a period 'exceeding 12 months' for NBFC-ML and above)***

(iv) Loss Asset shall mean:

(a) an asset which has been identified as loss asset by the NBFC or its internal or external auditor or by the Reserve Bank during the inspection of the applicable NBFC, to the extent it is not written off by the applicable NBFC; and

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(b) an asset which is adversely affected by a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security or due to any fraudulent act or omission on the part of the borrower.

(v) **Non-Performing Asset (referred as "NPA") shall mean:**

(a) an asset, in respect of which, interest has remained overdue for a period of more than 180 days.

(b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of more than 180 days or on which interest amount remained overdue for a period of more than 180 days.

(c) a demand or call loan, which remained overdue for a period of more than 180 days from the date of demand or call or on which interest amount remained overdue for a period of more than 180 days.

(d) a bill which remains overdue for a period of more than 180 days.

(e) the interest in respect of a debt or the income on receivables under the head 'other current assets' in the nature of short-term loans/advances, which facility remained overdue for a period of more than 180 days.

(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of more than 180 days.

(g) the lease rental and hire purchase instalment, which has become overdue for a period of more than 180 days.

(h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/ beneficiary when any of the above credit facilities becomes non-performing asset.

[Provided that in the case of lease and hire purchase transactions, an applicable NBFC shall classify each such account on the basis of its record of recovery.]

Note: The period of more than 180 days for NPA classification as mentioned above shall be adjusted as per glide path outlined as under.

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Non-Performing Asset (referred as "NPA") Glide Path:

The extant NPA classification norm stands changed to the overdue period of more than 90 days for applicable NBFCs. A glide path is provided to applicable NBFCs to adhere to the 90 days NPA norm as under –

– NPA Norms	*Timeline*
>150 days overdue	*By March 31, 2024*
>120 days overdue	*By March 31, 2025*
> 90 days	*By March 31, 2026*

Note: The glide path will not be applicable to NBFCs which are already required to follow the 90-day NPA norm.

3.3 Provisioning Requirements

The provisioning requirements as given below shall apply to every applicable NBFC (except NBFC-MFIs): Every applicable NBFC shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets as provided hereunder:

The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as under:

(i) Loss Assets: The entire asset shall be written off. If the assets are permitted to remain in the books for any reason,100% of the outstanding shall be provided for;

(ii) Doubtful Assets:

(a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the applicable NBFC has a valid recourse shall be made. The realisable value is to be estimated on a realistic basis;

(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20% to 50% of the secured portion (i.e. Estimated realisable value of the outstanding) shall be made on the following basis:

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Period for which the asset has been considered as doubtful	Percent of provision
Up to one year	20
One to three years	30
More than three years	50

(iii) **Sub-standard assets:** A general provision of 10 percent of total outstanding shall be made.

(iv) ***Standard asset provisioning (except NBFC-ML and above): NBFC-BL shall make provision for standard assets at 0.25 percent of the outstanding, which shall not be reckoned for arriving at net NPAs. The provision towards standard assets need not be netted from gross advances but shall be shown separately as 'Contingent Provisions against Standard Assets' in the balance sheet.***

Standard asset provisioning (Not applicable for NBFC-UL) NBFC shall make provisions for standard assets at 0.40 percent of the outstanding, which shall not be reckoned for arriving at net NPAs. The provision towards standard assets need not be netted from gross advances but shall be shown separately as 'Contingent Provisions against Standard Assets' in the balance sheet.

The above regulatory requirements are to be amended in a phased manner under the Scale-Based Regulation prescribed by RBI for NBFCs.

[Students may refer Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023 for detailed guidelines on prudential norms relating to Non-Banking Financial Companies covered in these Directions.]

4. AUDIT PROCEDURES

The following are the necessary steps involved -

(1) **Ascertaining the Business of the Company -** The first step in carrying out the audit of NBFC is to scan through the Memorandum and Articles of Association of the company, so as to acquaint oneself with the type of business that the company is engaged into. Normally, the Memorandum of Association of any company would be very wide in scope thereby permitting

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it to undertake a host of business activities, but companies generally lend to specialise in and focus on a few select activities. An auditor should, therefore, make a careful study of the business policy of the company so as to ascertain its principal business activities. For this purpose, an auditor may also scan through the minutes of the Board/Committee Meetings and hold discussions with the top level management to ascertain the corporate business plan/strategy which would give him a clear picture as to the principal objects of the company. An auditor should then independently corroborate his findings with the actual business done by the company, as reflected by the company's financial results.

The task of ascertaining the principal business activity of any NBFC is of paramount importance since the very classification of a company as an NBFC and its further classification would all depend upon its principal business activity. Based on the classification of a company, it will be required to comply with the provisions relating to limits on acceptance of public deposits as contained in the NBFC Public Deposit Directions.

(2) **Evaluation of Internal Control System -** The responsibility of maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of its business vests with the management. A sound internal control system would enable an organisation to plug loopholes in its workings, particularly in the detection of frauds and would also aid in timely decision making. An auditor should gain an understanding of the accounting system and related internal controls adopted by the NBFC to determine the nature, timing and extent of his audit procedures. An auditor should also ascertain whether the internal controls put in place by the NBFC are adequate and are being effectively followed.

In particular, an auditor should review the effectiveness of the system of recovery prevalent at the NBFC. He should ascertain whether the NBFC has an effective system of periodical review of advances in place which would facilitate effective monitoring and follow up. The absence of a periodical review system could result in non-detection of sticky advances at their very inception which may ultimately result in the NBFC having an alarmingly high level of NPAs.

(3) **Registration with the RBI -** Section 45-IA inserted in the RBI Act, 1934, w.e.f. 9th January, 1997, has made it incumbent on the part of all NBFCs to comply with registration requirements and have minimum net owned funds (NOF) of ₹ 10 crore (Although the requirement of minimum NOF at present stands at ₹ 200 lakh, . However, for strengthening the financial sector and technology adoption, and in view of the increasing



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complexities of services offered by NBFCs, it shall be mandatory for all NBFCs to raise minimum NOF to ₹ 10 crore) for commencing/ carrying on its business. An auditor should obtain a copy of the certificate of registration granted by the RBI or in case the certificate of registration has not been granted, a copy of the application form filed with the RBI for registration. It may particularly be noted that NBFCs incorporated after 9th January, 1997 are not entitled to commence business without first obtaining a registration certificate from the RBI. An auditor should, therefore, verify whether the dual conditions relating to registration with the RBI and maintenance of minimum net owned funds have been duly complied with by the concerned NBFC.

Every NBFC holding public deposits is required to invest a specified percentage (as the RBI may specify from time to time). The RBI has also prescribed a format for reporting to ensure compliance with the requirement of maintenance of liquid assets on a quarterly basis. This quarterly return (duly signed by an officer of the NBFC) is required to be submitted within prescribed time limit from the end of the relevant quarter and with reference to investments held in approved securities during the relevant quarter. The auditor should ascertain whether investment in prescribed liquid assets have been made and whether quarterly returns as mentioned above have been regularly filed with the RBI by the concerned NBFC.

(4) NBFC Acceptance of Public Deposit Directions (Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016) - The auditors must ascertain whether the company properly classified as per the requirements of various regulations. In case, the NBFC has not been classified by the RBI, the classification of a company will have to be determined after a careful consideration of various factors such as particulars of earlier registration granted, if any, particulars furnished in the application form for registration, company's Memorandum of Association and its financial results. Thereafter, it must be ascertained whether the company has complied with the following aspects in relation to the activity of mobilisation of public deposits:

(i) The ceiling on quantum of public deposits has been linked to its credit rating as given by an approved credit rating agency. Obtain a copy of the credit rating assigned to NBFC and check whether the public deposits accepted/held by it are in accordance with the level of credit rating assigned to it.

In the event of a upgrading/downgrading of credit rating, the auditor should bear in mind that the NBFC will have to increase/reduce its public deposits in accordance with

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the revised credit rating assigned to it within a specified time frame and should ensure that the NBFC has informed about the same to the RBI in writing.

In the event of downgrading of credit rating below the minimum specified investment grade, a non-banking financial company, being an investment and credit company or a factor, shall regularise the excess deposit as provided hereunder:

(a) with immediate effect, stop accepting fresh public deposits and renewing existing deposits;

(b) all existing deposits shall run off to maturity; and

(c) report the position within 15 working days, to the concerned Regional Office of the RBI where the NBFC is registered.

Provided no matured public deposit shall be renewed without the express and voluntary consent of the depositor.

(ii) Test check the interest calculations in respect of public deposits mobilised by an NBFC to ascertain that the NBFC has not paid interest in excess as per specification.

Likewise, test check the brokerage/ commission/ incentive calculations with the bills and vouchers for reimbursement of out of pocket expenses submitted by the parties to ascertain that the NBFC has not paid brokerage/ commission/ incentive/ reimbursement of expenses in excess as per specification.

(iii) Ascertain whether the NBFC has accepted or renewed any public deposit only after a written application form the depositor in the form to be supplied by the company, and shall contain all particulars specified in the Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977. Further ensure whether it contain the specific category of depositor, i.e., whether depositor is a shareholder or a director or a promoter or a member of public.

(iv) Verify the deposit register maintained by NBFC and test check the particulars that have been entered therein in respect of each depositor with supporting receipts issued to the depositors. Also check whether the NBFC is regularly paying its deposits on due dates and in the case of a delay/default, the reasons for the delay/default and the actual date of payment.

(v) Check whether the investments made in approved liquid assets by NBFC holding public deposits have been lodged in safe custody with a designated scheduled

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commercial bank as required by the NBFC Acceptance of Public Deposits Directions and also whether. certificate was obtained from the RBI to that effect.

(vii) Check whether the NBFC has filed its prescribed returns in a timely manner.

(viii) In the case of NBFCs not accepting/holding public deposits, check whether a board resolution has been passed by the NBFC to the effect that it has neither accepted any public deposits nor would it accept any public deposits during the year.

(ix) In the case of Group Holding Investment Companies, check whether the NBFC has passed a board resolution to the effect that the company has invested or would invest/hold its investments in share and securities of group companies specifying the names of the companies. In addition to the above, group holding investment companies are required to give a further undertaking that it would not trade in such shares/securities and that it has neither accepted nor would it accept any public deposits during the year.

(5) NBFC Prudential Norms -

(i) Check compliance with prudential norms encompassing income recognition, income from investments, accounting standards, accounting for investments, asset classification, provisioning for bad and doubtful debts, capital adequacy norms, prohibition on granting of loans by NBFC against its own shares, prohibition on loans and investments for failure to repay public deposits and norms for concentration of credit/investments.

(ii) An auditor should ensure that the Board of Directors of every NBFC granting/intending to grant demand/call loans shall frame and implement a policy for the company.

(iii) An auditor should assess on the basis of examinations conducted by him whether the NBFC has complied with the prudential norms. In particular, he should verify that advances and other credit facilities have been properly classified as standard/substandard/doubtful/loss and that proper provision has been made in accordance with the Directions.

(iv) In respect of Non-Performing Assets, an auditor should check whether the unrealised income in respect of such assets has not been taken to the Profit & Loss Account on an accrual basis. Income from NPAs should be accounted for on realisation basis only.

(v) Check whether all accounts which have been classified as NPAs in the previous year also continue to be shown as such in the current year also. If the same is not treated

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as an NPA in the current year, the auditor should specifically examine such accounts to ascertain whether the account has become regular and the same can be treated as performing as per the Directions.

TEST YOUR UNDERSTANDING 1

"Fin crazy" is a P2P online platform owned by Future Technologies Pvt. Limited which is registered with RBI as NBFC. Peer to Peer Platform (P2P) means an intermediary providing the services of loan facilitation via online medium or otherwise to the participants.

Participants have to enter into an arrangement with NBFC-P2P to lend on its platform or avail loan facilitation services provided by it. It provides only as a medium connecting lenders and borrowers. It also carries out the credit assessment and risk profiling of the participants on the platform. It also provides services relating to loan documentation and loan recovery. The company falls outside purview of upper layer.

Where does such NBFC fit in accordance with scale-based regulations? Suggest a few audit procedures for above NBFC-P2P.

5. CLASSIFICATION OF FRAUDS BY NBFC

In order to have uniformity in reporting, frauds have been classified as under based mainly on the provisions of the Indian Penal Code:

(a) Misappropriation and criminal breach of trust.

(b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

(c) Unauthorised credit facilities extended for reward or for illegal gratification.

(d) Negligence and cash shortages.

(e) Cheating and forgery.

(f) Irregularities in foreign exchange transactions.

(g) Any other type of fraud not coming under the specific heads as above.

Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred to in items (d) and (f) above are to be reported as fraud if the intention to cheat/ defraud is

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suspected/ proved. However, the following cases where fraudulent intention is not suspected/ proved, at the time of detection, will be treated as fraud and reported accordingly:

(a) cases of cash shortages more than ₹ 10,000/- and

(b) cases of cash shortages more than ₹ 5000/- if detected by management/ auditor/ inspecting officer and not reported on the occurrence by the persons handling cash.

NBFCs, covered in Master Direction - Monitoring of Frauds in NBFCs (Reserve Bank) Directions, 2016, having overseas branches/offices should report all frauds perpetrated at such branches/offices also to the Reserve Bank as per the prescribed format and procedures.

6. AUDIT CHECK-LIST

Some important points that may be covered in the audit of NBFCs, in addition to the audit points that may be covered for companies in general, are given below:

(eg. NBFC - Investment and Credit Company (NBFC-ICC)

i. Physically verify all the shares and securities held by NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.

ii. Verify whether the NBFC has not advanced any loans against the security of its own shares.

iii. Verify that dividend income wherever declared by a company, has been duly received by an NBFC and interest wherever due [except in case of NPAs] has been duly accounted for. NBFC Prudential Norms require dividend income on shares of companies and units of mutual funds to be recognised on cash basis. However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its Annual General Meeting and its right to receive the payment has been established. Income from bonds/debentures of corporate bodies is to be accounted on accrual basis only if the interest rate on these instruments is predetermined and interest is serviced regularly and not in arrears.

iv. Test check bills/contract notes received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.

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v. Verify the Board Minutes for purchase and sale of investments. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long-Term Investments.

vi. Check whether the investments have been valued in accordance with the NBFC Prudential Norms and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.

vii. Obtain a list of subsidiary/group companies from the management and verify the investments made in subsidiary/group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares and whether the Valuation is as per Prudential norms.

viii. Check whether investments in unquoted debentures/bonds have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.

ix. An auditor will have to ascertain whether the requirements of AS 13 "Accounting for Investments" or other accounting standard, as applicable, (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

x. In respect of shares/securities held through a depository, obtain a confirmation from the depository regarding the shares/securities held by it on behalf of the NBFC.

xi. Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon).

xii. Verify charges received or paid in respect of securities lend/borrowed.

xiii. Obtain a confirmation from the approved intermediary regarding securities deposited with/borrowed from it as at the year end.

xiv. An auditor should examine whether each loan or advance has been properly sanctioned. He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.

xv. An auditor should verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. He must ascertain the nature and

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value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.

xvi. Obtain balance confirmations from the concerned parties.

xvii. As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscounted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.

xviii. Check whether the NBFC has not lent/invested in excess of the specified limits to any single borrower or group of borrowers as per NBFC Prudential Norms.

xix. An auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyse the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.

xx. Check the classification of loans and advances (including bills purchased and discounted) made by NBFC into Standard Assets, Sub-Standard Assets, Doubtful Assets and Loss Assets and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms.

(Note: The above checklist is not exhaustive. It is only illustrative. There could be various other audit procedures which may be performed for audit of an NBFC. Based on the nature and size of the NBFC, the auditor will have to perform specific audit techniques in that regard)



7. AUDITOR'S DUTY

The following are the important duties of an auditor -

7.1 Compliance with NBFC Auditor's Report - RBI Directions

The RBI Directions have considerably increased the responsibility of auditors of NBFCs. A very onerous task of reporting to the Board of Directors on certain specified matters and to the RBI on an exception basis has been imposed upon him. This reporting requirement is in addition to the normal reporting requirements to the shareholders under section 143 of the Companies Act, 2013.

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Auditors will, thus, have to be very careful whilst carrying out audits of NBFCs to ensure that all matters which they are required to take into consideration for the purposes of reporting to the RBI have been taken due care of.

Section 45MA of the Reserve Bank of India Act, 1934 was introduced with effect from 13.12.1974. Under this provision the auditor of a non-banking financial company or a non-banking miscellaneous company which has accepted public deposits, has to inquire whether or not the company has furnished to the Reserve Bank of India statements, information of particulars relating to the deposits as are required to the furnished under Chapter IIIB of the Reserve Bank of India Act, 1934. The provision further states that if on inquiry the auditor is not satisfied about the compliance by the company, it is his duty to make to the Reserve Bank of India giving the aggregate amount of deposits held by the company. The auditor is also required to incorporate the report or intended to be made to the Reserve Bank of India in his report to the company under Section 143 of the Companies Act, 2013.

Report to Board of Directors under RBI Directions as per Master Direction – Reserve Bank of India (Filing of Supervisory Returns) Directions - 2024

(1) The Reserve Bank of India (RBI) has issued Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016 (the Directions) to auditor of every non-banking financial companies.

(2) The Directions shall apply to every auditor of a non-banking financial company as defined in section 45 I(f) of the Reserve Bank of India Act, 1934.

Auditors to submit additional Report to the Board of Directors: In addition to the Report made by the auditor under Section 143 of the Companies Act, 2013 or section 227 of the Companies Act, 1956 (Act 1 of 1956) on the accounts of a non-banking financial company examined for every financial year ending on any day on or after the commencement of these Directions, the auditor shall also make a separate report to the Board of Directors of the Company on the matters specified in paragraphs 3 and 4 below.

(3) **Material to be included in the Auditor's report to the Board of Directors:** The auditor's report on the accounts of a non-banking financial company shall include a statement on the following matters, namely –

(A) In the case of all non-banking financial companies:

I. Conducting Non-Banking Financial Activity without a valid Certificate of Registration (CoR) granted by the RBI is an offence under chapter V of the RBI Act, 1934. Therefore, if the company is engaged in the business of non-banking

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financial institution as defined in section 45-I (a) of the RBI Act and meeting the Principal Business Criteria (Financial asset/income pattern) as laid down vide the RBI's press release dated April 08, 1999, and directions issued by DNBR, auditor shall examine whether the company has obtained a Certificate of Registration (CoR) from the RBI.

II. In case of a company holding CoR issued by the RBI, whether that company is entitled to continue to hold such CoR in terms of its Principal Business Criteria (Financial asset/income pattern) as on March 31 of the applicable year.

III. Whether the non-banking financial company is meeting the required net owned fund requirement as laid down in ***Master Direction*** – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023 and Deposit taking Company (Reserve Bank) Directions, 2016.

Note: Every non-banking financial company shall submit a Certificate from its Statutory Auditor that it is engaged in the business of non-banking financial institution requiring it to hold a Certificate of Registration under Section 45-IA of the RBI Act and is eligible to hold it. A certificate from the Statutory Auditor in this regard with reference to the position of the company as at end of the financial year ended March 31st may be submitted to the Regional Office of the Department of Non-Banking Supervision under whose jurisdiction the non-banking financial company is registered, ***within 5 working days from the date of signing of the Auditor's report in terms of section 134 of the Companies Act, 2013, but not later than December 31st of same year, in any case.***

The format of Statutory Auditor's Certificate (SAC) to be submitted by NBFCs has been issued vide Master Direction – Reserve Bank of India (Filing of Supervisory Returns) Directions - 2024.

(B) In the case of non-banking financial companies accepting/holding public deposits

Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely-

(i) Whether the public deposits accepted by the company together with other borrowings indicated below viz.

(a) from public by issue of unsecured non-convertible debentures/bonds;

(b) from its shareholders (if it is a public limited company); and

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(c) from entities which are not excluded from the definition of 'public deposit' in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016, are within the limits admissible to the company as per the provisions of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(ii) Whether the public deposits held by the company in excess of the quantum of such deposits permissible to it under the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 are regularised in the manner provided in the said Directions;

(iii) Whether the non-banking financial company is accepting "public deposit" without minimum investment grade credit rating from an approved credit rating agency as per the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(iv) Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in terms of the ***Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023*** has been correctly determined and whether such ratio is in compliance with the minimum CRAR prescribed therein;

(v) In respect of non-banking financial companies referred to in clause (iii) above,

(a) whether the credit rating, for each of the fixed deposits schemes that has been assigned by one of the Credit Rating Agencies listed in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 is in force; and

(b) whether the aggregate amount of deposits outstanding as at any point during the year has exceeded the limit specified by the such Credit Rating Agency;

(vi) Whether the company has violated any restriction on acceptance of public deposit as provided in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(vii) Whether the company has defaulted in paying to its depositors the interest and/or principal amount of the deposits after such interest and/or principal became due;

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(viii) Whether the company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments as specified in the Directions issued by the Bank in terms of the ***Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023;***

(ix) Whether the company has complied with the liquid assets requirement as prescribed by the Bank in exercise of powers under section 45-IB of the RBI Act and whether the details of the designated bank in which the approved securities are held is communicated to the office concerned of the RBI in terms of NBS 3; Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(x) Whether the company has furnished to the RBI within the stipulated period the return on deposits as specified in the ***DNBS 01*** to ***– Master Direction – Reserve Bank of India (Filing of Supervisory Returns) Directions - 2024***;

(xi) Whether the company has furnished to the RBI within the stipulated period the quarterly return on prudential norms as specified in the ***Master Direction – Reserve Bank of India (Filing of Supervisory Returns) Directions - 2024;***

(xii) Whether, in the case of opening of new branches or offices to collect deposits or in the case of closure of existing branches/offices or in the case of appointment of agent, the company has complied with the requirements contained in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

(C) In the case of a non-banking financial company not accepting public deposits

Apart from the aspects enumerated in (A) above, the auditor shall include a statement on the following matters, namely: -

(i) Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits;

(ii) Whether the company has accepted any public deposits during the relevant period/year;

(iii) Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of ***Master***

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Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023;

(iv) (a) Whether the capital adequacy ratio as disclosed in the return submitted to the RBI in form NBS - 7, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the RBI;

(b) Whether the company has furnished to the RBI the annual statement of capital funds, risk assets/exposures and risk asset ratio (NBS-7) within the stipulated period.

(v) whether the non-banking financial company has been correctly classified as NBFC Micro Finance Institutions (MFI) as defined in the ***Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023.***

(D) In the case of a company engaged in the business of non-banking financial institution not required to hold CoR subject to certain conditions

Apart from the matters enumerated in (A)(I) above where a company has obtained a specific advice from the RBI that it is not required to hold CoR from the RBI, the auditor shall include a statement that the company is complying with the conditions stipulated as advised by the RBI.

(4) **Reasons to be stated for unfavourable or qualified statements:** Where, in the auditor's report, the statement regarding any of the items referred to in paragraph 3 above is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified statement, as the case may be. Where the auditor is unable to express any opinion on any of the items referred to in paragraph 3 above, his report shall indicate such fact together with reasons therefor.

(5) **Obligation of auditor to submit an exception report to the RBI**

(I) Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavorable or qualified, or in the opinion of the auditor the company has not complied with:

(a) the provisions of Chapter III B of RBI Act (Act 2 of 1934); or

(b) Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or

(c) ***Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023.***

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It shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

(II) The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

7.2 Compliance with CARO 2020

As per CARO 2020, the auditor is required to report that –

I. Whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, If so,

(a) whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest;

(b) in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

(c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;

(d) whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in clause (76) of section 2 of the Companies Act, 2013; [Paragraph 3(iii)]

(II) (a) Whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

(b) Whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934;

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(c) Whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria;

(d) Whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group; [Paragraph 3(xvi)]

(**Note: Students are required to refer Guidance Note on CARO, 2020 for more details**).

TEST YOUR UNDERSTANDING 2

Sugam Housing Finance Limited is in the business of housing finance activities having asset size of ₹ 800 crores. Its principal business is of providing finances for housing mainly to individuals. It is not identified by RBI in upper layer. Under scale-based regulations introduced by RBI, what should be appropriate classification for such a company?

Is there any specific reporting requirement under CARO, 2020 for statutory auditor of a company engaged in housing finance activities?

8. INDIAN ACCOUNTING STANDARDS (IND AS)

8.1 Applicability of Indian Accounting Standards (Ind AS) on NBFCs

NBFCs are required to comply with Indian Accounting Standards (Ind AS) as per Rule 4 (1)(iv) of the Companies (Indian Accounting Standards) Rules, 2015 and as amended by the Companies (Indian Accounting Standards) (Amendment) Rules, 2023.

8.2 Format for Preparation of Financial Statements by NBFCs under Ind- AS

The Ministry of Corporate Affairs (MCA) vide notification dated October 11, 2018 introduced Division III under Schedule III of the Companies Act, 2013, wherein a format for preparation of financial statements by NBFCs complying with Ind AS has been prescribed.

Every NBFC required to comply with Ind AS shall prepare its financial statements as per below format:

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Illustrative format of Balance Sheet under Division III of Schedule III-

Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of previous reporting period (₹)
ASSETS			
(1) Financial Assets (a) Cash and cash equivalents (b) Bank balance other than (a) above (c) Derivative financial instruments (d) Receivables (1) Trade Receivables (2) Other Receivables (e) Loans (f) Investments (g) Other Financial assets			
(2) Non-Financial Assets (a) Inventories (b) Current tax assets (net) (c) Deferred tax assets (net) (d) Investment property (e) Biological assets other than bearer plants (f) Property, Plant and Equipment (g) Capital work-in-progress (h) Intangible assets under development (i) Goodwill (j) Other intangible assets (k) Other non-financial assets (to be specified)			
Total Assets			

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Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of previous reporting period (₹)
LIABILITES AND EQUITY			
LIABILITIES			
(1) Financial Liabilities (a) Derivative financial instruments (b) Payables (I) Trade Payables (i) total outstanding dues of micro enterprises and small enterprises (ii) total outstanding dues of creditors other than micro enterprises and small enterprises (II) Other Payables (i) total outstanding dues of micro enterprises and small enterprises (ii) total outstanding dues of creditors other than micro enterprises and small enterprises (c) Debt Securities (d) Borrowings (other than debt securities) (e) Deposits (f) Subordinated liabilities (g) Other financial liabilities (to be specified)			
(2) Non-financial Liabilities (a) Current tax liabilities (net) (b) Provisions			

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Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of previous reporting period (₹)
(c) Deferred Tax Liabilities (net) (d) Other non-financial liabilities (to be specified)			
(3) Non-financial Capital (a) Equity share capital (b) Other equity			
Total Liabilities and Equity			

Illustrative format of Statement of Profit and Loss prescribed under Division III of Schedule III

Particulars	Notes No.	Figures for the current reporting period (₹)	Figures for the previous reporting period (₹)
Revenue from operations (a) Interest Income (b) Dividend income (c) Rental income (d) Fee and commission income (e) Net gain on fair vale changes (f) Net gain on derecognition of financial instruments under amortised category (g) Sale of products (including Excise duty) (h) Sale of services (i) Others (to be specified)			
Total revenue from operations (I)			
Other income (to be specified) (II)			
Total Income (III= I + II)			

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Particulars	Notes No.	Figures for the current reporting period (₹)	Figures for the previous reporting period (₹)
Expenses (a) Finance costs (b) Fees and commission expense (c) Net loss on fair vale changes (d) Net loss on derecognition of financial instruments under amortised category (e) Impairment on financial instruments (f) Cost of material consumed (g) Purchases of stock-in-trade (h) Changes in Inventories of finished goods, stock-in-trade and work-in-progress (i) Employee Benefits Expenses (j) Depreciation, amortization and impairment (k) Other expenses (to be specified			
Total Expenses (IV)			
Profit / (loss) before exceptional items and tax (V= III - IV)			
Exceptional items (VI)			
Profit / (loss) before tax (VII= V - VI)			
Tax Expense (VIII): (1) Current tax (2) Deferred tax			
Profit / (loss) for the period from continuing operations (IX= VII - VIII)			
Profit / (loss) for the period from discontinued operations (X)			
Tax Expense of discontinued operations (XI)			

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Particulars	Notes No.	Figures for the current reporting period (₹)	Figures for the previous reporting period (₹)
Profit / (loss) for the period from discontinued operations after tax (XII= X - XI)			
Profit / (loss) for the period (XIII= IX + XII)			
Other Comprehensive Income (XIV)			
(A) (i) Items that will not be reclassified to profit or loss (specify items and amounts) (ii) income tax relating to items that will not be reclassified to profit or loss SUB-TOTAL (A)			
(B) (i) Items that will be reclassified to profit or loss (specify items and amounts) (ii) income tax relating to items that will be reclassified to profit or loss SUB-TOTAL (B)			
Other Comprehensive Income (A+B)			
Total Comprehensive Income for the period (XV = XIII + XIV) (Comprising Profit (Loss) and other Comprehensive Income for the period)			
Earnings per equity share (for continuing operations) (XVI) Basic (₹) Diluted (₹)			
Earnings per equity share (for discontinued operations) (XVII) Basic (₹) Diluted (₹)			

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Particulars	Notes No.	Figures for the current reporting period (₹)	Figures for the previous reporting period (₹)
Earnings per equity share (for continuing and discontinued operations) (XVIII) Basic (₹) Diluted (₹)			

Note : Student may also refer illustrative format of Statement of Changes in Equity prescribed under Division III of Schedule III for more understanding.

8.3 Difference between Division II (Ind- AS- Other than NBFCs) and Division III (Ind- AS- NBFCs) of Schedule III

The presentation requirements under Division III for NBFCs are similar to Division II (Non NBFC) to a large extent except for the following:

(a) NBFCs have been allowed to present the items of the balance sheet in order of their liquidity which is not allowed to companies required to follow Division II.

(b) An NBFC is required to separately disclose by way of a note any item of 'other income' or 'other expenditure' which exceeds 1 per cent of the total income. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds 1 per cent of *the revenue from operations or ₹10 lakhs, whichever is higher.*

(c) NBFCs are required to separately disclose under 'receivables', the debts due from any Limited Liability Partnership (LLP) in which its director is a partner or member.

(d) NBFCs are also required to disclose items comprising 'revenue from operations' and 'other comprehensive income' on the face of the Statement of profit and loss instead of showing those only as part of the notes.

(e) Separate disclosure of trade receivable which have significant increase in credit risk & credit impaired

(f) The conditions or restrictions for distribution attached to statutory reserves have to be separately disclose in the notes as stipulated by the relevant statute.

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TEST YOUR UNDERSTANDING 3

You are auditor of a deposit taking NBFC (NBFC-D). The NBFC is identified by RBI in its upper layer and its financial statements are required to be prepared in accordance with requirements of Ind AS. The following is extract of statement of profit and loss for year ending 31 St March, 2024 in accordance with Division III of Schedule III of the Companies Act, 2013. Previous year figures are ignored.

Particulars	Note No.	Figures for year ended 31st March, 2024 (in ₹ Crores)
Revenue from Operations		
(i) Interest income	15	9500
(ii) Dividend income		-
(iii) Rental Income		150
(iv) Fees and commission income	16	100
(v) Net gain on fair value changes	17	150
(vi) Net gain on derecognition of financial instruments under amortised category		
(I) Total revenue from operations		9900
(II) Other Income	18	100
(III) Total Income		10000

On going through details of head "other expenditure" in expenses side of statement of profit and loss, it is noticed that there is an expenditure relating to manpower outsourcing cost amounting to ₹ 99.50 crores included under "other expenditure".

Does it meet the requirements of Division III of Schedule III of the Companies Act, 2013?

Key Takeaways

- A company incorporated under the Companies Act and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to the Reserve Bank of India in prescribed form along with necessary documents for registration. The RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

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- A non-banking company is defined under RBI Act as:-

  (i) A financial institution which is a company;

  (ii) A non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

  (iii) Such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

  Further, in order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as NBFC when a company's financial assets constitute more than 50 per cent of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by RBI.

- RBI has issued directions to non-banking financial companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs.

- RBI has introduced scale based regulations for NBFCs based on four layers that are defined based on their size, activity, and perceived riskiness. The four layers are- Base layer, middle layer, upper layer and top layer.

- NBFCs lend like banks. However, such entities cannot accept demand deposits although some can accept term deposits. These also do not form part of payment and settlement system. DICGC cover is not available to depositors of NBFCs. No minimum exposure to priority sector is required by NBFCs.

- Every applicable NBFC shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets in accordance with prescribed norms.

- Audit procedures for NBFCs have to be tailored in accordance of nature of business of NBFC and regulatory directions.

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- Besides issuing a report in accordance with requirements of section 143(3) of the Companies Act, 2013 and covering matters specified under CARO, 2020, statutory auditor of NBFC is also required to submit an additional report to Board of Directors of the company.
- The Reserve Bank of India (RBI) has issued Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016 (the Directions) to auditor of every non-banking financial company in this regard. Under these directions, the auditor of an NBFC has to submit an additional report to the Board of Directors of the company covering matters specified in these directions.

Circular on Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCS: SCAN ME !

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Define NBFC. Also give a brief description about types of NBFCs covering any five NBFCs.*
2. *Shubham & Associates are going to start the audit of NBFCs. They have not performed much work for the NBFCs in the past years. You are required to explain the requirements related to registration and regulation of NBFCs which an auditor needs to keep in his mind while planning the audit of NBFC which would help this firm.*

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3. *Satyam Pvt Ltd is a company engaged in trading activities, it also has made investments in shares of other Companies and advanced loans to group companies amounting to more than 50% of its total assets. However, trading income constitutes majority of its total income. Whether the Company is an NBFC?*

4. *Shivam & Co LLP are the auditors of NBFC (Investment and Credit Company). Some of the team members of the audit team who audited this NBFC have left the firm and the new team members are in discussion with the previous team members who are still continuing with the firm regarding the verification procedures to be performed. In this context, please explain what verification procedures should be performed in relation to the audit of NBFC - Investment and Credit Company (NBFC-ICC).*

5 *You are appointed as the auditor of an NBFC registered with the RBI and which is accepting and holding public deposits. You are considering your reporting requirement in addition to your report made under Section 143 of the Companies Act, 2013 on the accounts of this NBFC as per the prescribed Directions.*

Please explain what points are required to be known in respect of the separate report to be given by you to the Board of Directors of this NBFC.

6. *Kamna & Co LLP, a firm of Chartered Accountants, was appointed as auditor of an NBFC. The audit work has been completed. The audit team which was involved in the fieldwork came across various observations during the course of audit of this NBFC and have also limited understanding about the exceptions which are required to be reported in the audit report. They would like to understand in detail regarding the obligations on the part of an auditor in respect of exceptions in his report so that they can conclude their work. Please explain.*

7. *The Statutory Auditor of the NBFC company is required to give a report to the Board of Directors. What shall be the content of the Auditor's Report to the Board.*

8. *Krishna Pvt Ltd. is fulfilling the Principal Business Criteria as at the balance sheet date i.e. Financial Assets are more than 50% of total assets and Financial Income is more than 50% of Gross Income. What shall be the obligation of the Statutory Auditor in such a scenario?*

9. *Mr. G. has been appointed as an auditor of LMP Ltd., an NBFC company registered with RBI. Mr. G is concerned about whether the format of financial statements prepared by LMP Ltd. is as per notification issued by the Ministry of Corporate Affairs (MCA) dated October 11, 2018. The notification prescribed the· format in Division III under Schedule III of the Companies Act, 2013 applicable to NBFCs complying with Ind-AS. Mr. G wants to know the*

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differences in the presentation requirements between Division II and Division III of Schedule III of the Companies Act, 2013. Guide Mr. G.

10. *Abhimanyu Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. The company had net owned funds of ₹1,50,00,000/-(one crore fifty lakhs) and was not having registration certificate from RBI and applied for it on 30th March 2024. The company appointed Mr. Kabra as its statutory auditor for the year 2023-24. Advise the auditor with reference to auditor procedures to be taken and reporting requirements on the same in view of CARO 2020?*

11. ***Yo-Yo Finance Limited is NBFC-ML as per the revised categorisation of NBFC done by RBI. YAK & Associates, a firm of chartered accountants, are appointed as Statutory Auditors of the Company for the year 2023-24.***

The audit team consists of CA Y, 1 Audit Manager and 3 junior assistants. The Audit Manager has been recently appointed, who does not have much exposure in the field of Auditing of NBFCs. During the engagement team meeting, the Audit Manager asked CA Y, regarding the audit procedures to be undertaken to verify whether the aforesaid Company has followed Prudential Norms? As an Engagement partner suggest any four procedures to the Audit Manager.

12. **Singh Ltd. is a company registered under the Companies Act, 2013. The company is engaged in the business of loans and advances, acquisition of shares / stocks / bonds / debentures/securities issued by government or local authorities. For the year ended 31st March 2024, the following are some extracts from the financial statements:**

(i)	**Paid-up share capital**	**₹ 50 Cr.**
(ii)	**Non-Current Assets - Loans & Advances**	**₹ 61.75 Cr.**
(iii)	**Current Assets - Loans and advances**	**₹ 312.25 Cr.**
(iv)	**Total assets of the company**	**₹ 620 Cr.**
(v)	**Intangible assets**	**₹ 12 Cr.**
(vi)	**Profit for the Year**	**₹ 7.25 Cr.**
(vii)	**Income from interest and dividends**	**₹ 68 Cr.**
(viii)	**Gross income**	**₹ 118.75 Cr.**

Directors intend to apply for registration as Non-Banking Financial Company (NBFC) under Section 45-IA of the Reserve Bank of India (Amendment) Act, 1997. Advise.

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Answers to Test Your Understanding.

1. NBFC-P2P falls in base layer in accordance with scale-based regulations of RBI. Few audit procedures for NBFC-P2P are as under: -

- Gaining an understanding of business conducted by NBFC-P2P. It should be verified that the company undertakes only permissible activities applicable to such type of NBFCs like providing online market place to participants for lending and borrowing. It should not be engaged in the business of lending funds on its own.
- Verifying certificate of registration obtained from RBI for carrying business of P2P platform.
- Verifying Board approved policy setting out eligibility criteria for participants i.e lenders and borrowers.
- Verifying board approved policy for pricing of services provided by P2P platform
- Verification of adherence to lending and borrowing guidelines prescribed by RBI
- Verifying appropriate arrangements have been entered into among participants and NBFC-P2P.
- Compliance with reporting requirements of RBI
- Verifying board approved policy for grievance redressal and complaints

2. The said company is not identified in upper layer by RBI. Under scale-based regulations introduced by RBI, NBFCs undertaking housing finance activities constitute "middle layer". The asset size is not relevant in such a case. All housing finance companies not identified in upper layer would constitute middle layer due to nature of such activities undertaken by them.

There is specific reporting requirement under CARO, 2020 under clause 3 (xvi)(b) which requires auditor to report whether the company has conducted any non-Banking financial or housing finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934.

3. An NBFC is preparing financial statements in accordance with requirements of Division III of Schedule III of the Companies Act, 2013 has to separately disclose by way of note any item of "other expenditure" exceeding 1% of total income.

The said expenditure of ₹ 99.50 crore does not exceed 1% of total income. Hence, it meets requirements of Division III of Schedule III of the Companies Act, 2013.

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Answers to Theoretical Questions

1. Refer Para 1 – Definition and Types of NBFCs.

2. **An auditor should know following points regarding registration and regulation of NBFCs:** Under Section 45–IA of the RBI Act, 1934, no NBFC shall commence or carry on the business of a non-banking financial institution without

- obtaining a certificate of registration issued by the RBI; and
- having a net owned fund (NOF) of ₹ 25 lakhs (₹ Two crore since April 1999) not exceeding two hundred lakhs rupees, as the RBI may, by notification in the Official Gazette, specify.

(The RBI (Amendment) Act (1997) provided an entry point norm of ₹ 25 lakh as the **minimum NOF** which was revised upwards to ₹ 2 crore for new NBFCs seeking grant of certificate of registration (CoR) on or after 21 April 1999).

A company incorporated under the Companies Act and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to the RBI in prescribed form along with necessary documents for registration. The RBI issues CoR after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock Broking Companies registered with SEBI, Insurance Company holding a valid CoR issued by IRDA, Nidhi Companies as notified under Section 406 of the Companies Act, 2013, Chit Companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

The RBI has issued directions to NBFCs on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs.

Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of Directors and shareholders.

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3. In order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as NBFC when a company's financial assets constitute more than 50 per cent of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by Reserve Bank of India.

In the given case, though Satyam Pvt Ltd is fulfilling the criteria on the asset side, but however is not fulfilling the criteria on the income side, the company cannot be classified as a deemed NBFC.

4. Refer Para 6.

5. Refer Para 7.1(3), (4).

6. Refer Para 7.1(5).

7. Ref Para 7.1.

The statutory auditor of Karma Pvt Ltd, being NBFC is required to submit separate report to the Board of Directors on the matters as specified as below:

I. Conducting Non-Banking Financial Activity without a valid Certificate of Registration (CoR) granted by the RBI is an offence under chapter V of the RBI Act, 1934. Therefore, if the company is engaged in the business of non-banking financial institution as defined in section 45-I (a) of the RBI Act and meeting the Principal Business Criteria (Financial asset/income pattern) as laid down vide the RBI's press release dated April 08, 1999, and directions issued by DNBR, auditor shall examine whether the company has obtained a Certificate of Registration (CoR) from the RBI.

II. In case of a company holding CoR issued by the RBI, whether that company is entitled to continue to hold such CoR in terms of its Principal Business Criteria (Financial asset/income pattern) as on March 31 of the applicable year.

III. Whether the non-banking financial company is meeting the required net owned fund requirement as laid down in ***Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023.***

Apart from the aspects enumerated above, the auditor shall include a statement on the following matters, namely: -

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(i) Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits;

(ii) Whether the company has accepted any public deposits during the relevant period/year;

(iii) Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of ***Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023;***

Where, in the auditor's report, the statement regarding any of the items referred to matters specified above is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified statement, as the case may be. Where the auditor is unable to express any opinion on any of the items referred above, his report shall indicate such fact together with reasons thereof.

8. Ref Para 7.1.

In the given case, Krishna Pvt Ltd is fulfilling the Principal Business Criteria i.e. Financial Assets are more than 50 % of total assets and Financial Income is more than 50 % of Gross Income. The company which fulfils both these criteria shall qualify as an NBFC and hence is required to obtain Certificate of Registration (CoR) with Reserve Bank of India. In such a scenario, the statutory auditor has an obligation to submit exception report to the RBI on the following matters :

(I) Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 of the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016, is unfavourable or qualified, or in the opinion of the auditor the company has not complied with:

(a) the provisions of Chapter III B of RBI Act (Act 2 of 1934); or

(b) Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or

(c) Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023.

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It shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

(II) The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

9. Refer Para 8.3.

10. As per Clause (xvi) of Paragraph 3 of CARO 2020, the auditor is required to report that "whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained."

The auditor is required to examine whether the company is engaged in the business which attract the requirements of the registration. The registration is required where the financing activity is a principal business of the company. The RBI restricts companies from carrying on the business of a non-banking financial institution without obtaining the certificate of registration.

Audit Procedures and Reporting:

(i) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.

(ii) The financial statements should be examined to ascertain whether company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.

(iii) Whether the company has net owned funds as required for the registration as NBFC.

(iv) Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.

(v) The auditor should report incorporating the following:-

(1) Whether the registration is required under section 45-IA of the RBI Act, 1934.

(2) If so, whether it has obtained the registration.

(3) If the registration not obtained, reasons thereof.

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In the instant case Abhimanyu Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. The company was having net owned funds of ₹ 1,50,00,000/-(one crore fifty lakhs) which is less in comparison to the prescribed limit i.e. 2 crore rupees and was also not having registration certificate from RBI (though applied for it on 30th March 2024). The auditor is required to report on the same as per Clause (xvi) of Paragraph 3 of CARO, 2020.

11. Refer Para 4.5.

12. In order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the audited balance sheet of the previous year to decide its principal business. The company will be treated as NBFC when

(i) Financial assets of the company constitute more than 50 percent of the total assets (netted off by intangible assets) and

(ii) Income from financial assets of the company constitutes more than 50 percent of the gross income.

A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by RBI.

In the given case of Singh Ltd, its financial assets are ₹ 374 Crore i.e., (₹ 61.75 + ₹ 312.25)

Total Assets (netted off by intangible assets) = ₹ 608 Crore

Income from financial assets = ₹ 68 Crore

Gross Income = ₹ 118.75 Crore

From the above, it can be concluded that financial assets of Singh Ltd. constitute more than 50 per cent of the total assets (netted off by intangible assets) and income from financial assets of Singh Ltd. constitutes more than 50 per cent of the gross income. Hence, Singh Ltd. fulfills both the criteria to qualify as an NBFC.

Thus Singh Ltd. can apply for registration under Section 45-IA of the Reserve Bank of India (Amendment) Act, 1997 in prescribed form along with the necessary documents.

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CHAPTER 15

OVERVIEW OF AUDIT OF PUBLIC SECTOR UNDERTAKINGS



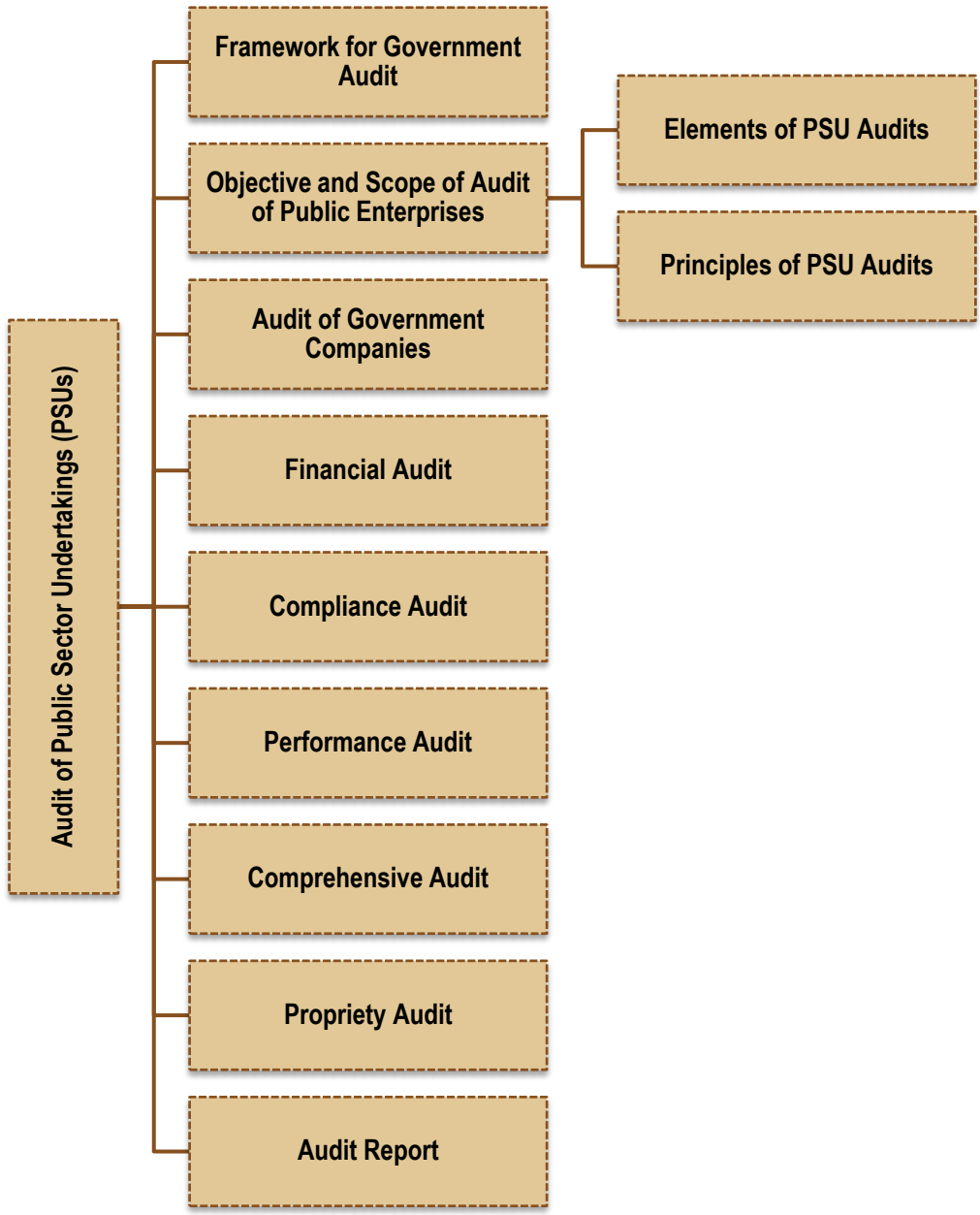
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the framework for government audit.
- Understand objective and scope of public enterprises audit.
- Explain the elements of PSU Audits and Principles of PSU Audits.
- Understand & explain the concept of Compliance Audit, Performance Audit, Comprehensive Audit & Propriety Audit in relation to C&AG of India.
- Comprehend about Audit report of the C&AG of India.
- Apply & analyse the above-mentioned concepts in moderately complex scenarios.

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CHAPTER OVERVIEW



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CA Smita joined the Indian Audit and Accounts Service after qualifying as a Chartered Accountant and passing a competitive exam. Her initial appointment was in the Mumbai office. As part of the audit team conducting test audit of a PSU in insurance sector, she was verifying whether company was in compliance with regulatory norms for issuing insurance policies. This audit was in the nature of a compliance audit.

During the audit, she found that company had issued policies to certain companies dealing in sale of mobile handsets. These companies offered free insurance to the customers for their mobiles to cover fire, theft and similar risks. Such an offer was, however, subject to the buying of their software application by customers in the stipulated time. It was found by her that no actuarial valuation was conducted before issuing these policies and required approvals from competent authorities were not in place. As a result, she found losses on account of claim settlement due to non-compliant underwriting.

She was also part of team conducting performance audit of a government owned steel company. The said company had undertaken modernization and expansion of its steel plants and the performance audit of company was carried out. Her team highlighted many deficiencies in areas ranging from project planning, tender finalisation and project execution. In each area, specific deficiencies were pointed out. For instance, the team found that all material projects were delayed and not completed in time. It was also pointed that, although there was growth in domestic steel industry in the period covered by audit but the company failed to take advantage of favourable market conditions due to these delays.

After a few years, she was posted in a northern state after promotion. Her responsibility included compiling a report on the financial performance of government companies and statutory corporations owned by the State Government. This report also included impact of significant comments as a result of supplementary audit of the financial statements of government companies conducted by the C&AG.

One such comment related to supplementary audit already carried out by C&AG pertained to the improper determination of depreciation in the financial statements of a state-owned power generation company. Its impact was highlighted in the report pointing out that said improper determination has led to overstatement of profits by ₹ 20 crore.

Such is encompassing reach of C&AG in relation to PSUs!

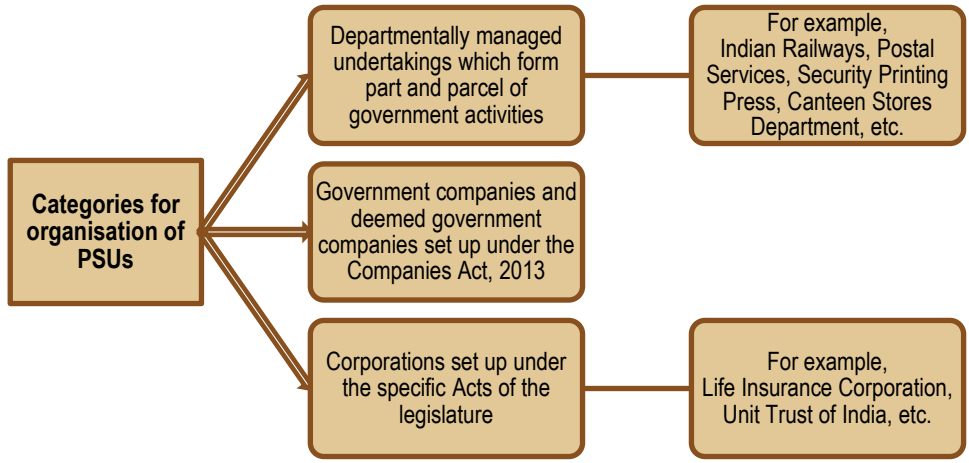
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1. INTRODUCTION

Public sector undertakings in India are fundamentally owned or controlled by Central Government, or any State Government or governments, or partly by the Central Government and one or more State Governments. The public enterprises have been assigned a key role in the socio-economic development of the country. These enterprises are industries supplying basic inputs to industry and agriculture, such as coal, oil, steel, minerals and metals, cement, chemicals and fertilizers and heavy equipment. Public utilities like the railways, postal and telecom services, electricity generation and supply, road transport, etc. constitute another class of public enterprises. Though in the past, the public sector in India has achieved a dominant role in the national economy, the private sector is also now actively allowed in various sectors like electricity generation, telecom services, etc.



Fig.: Audit of PSUs*





Source :- newsonair.com

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LIFE INSURANCE CORPORATION OF INDIA

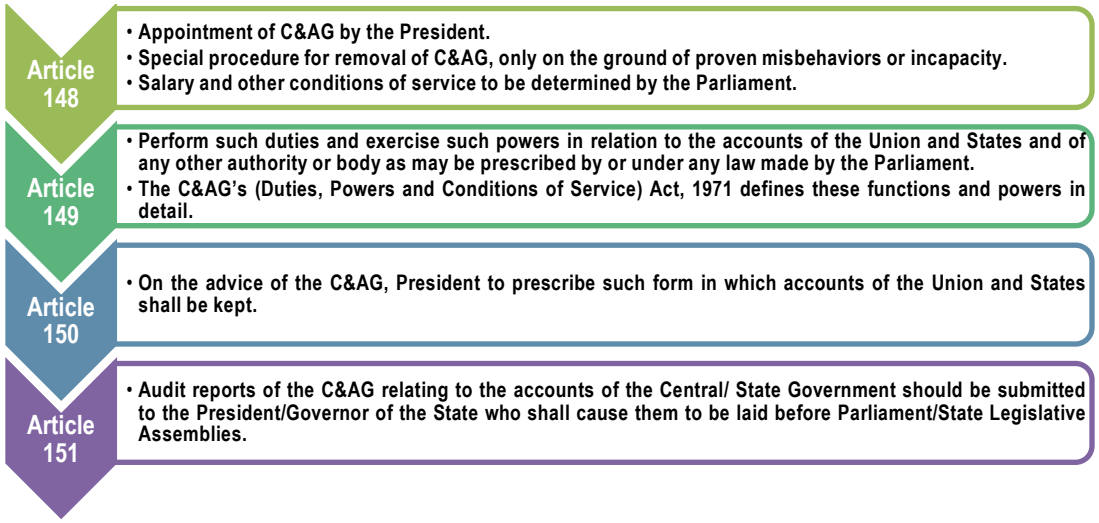
Source :- wikipedia.com

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2. FRAMEWORK FOR GOVERNMENT AUDIT

In India, the Government audit is performed by an independent constitutional authority, i.e. **Comptroller and Auditor General of India (C&AG)**, through the **Indian Audit and Accounts Department**. The Constitution of India gives a special status to the C&AG and contains provisions to safeguard his independence.

Article 148 to 151 of the Constitution prescribes the role of C&AG as follows:



The Comptroller and Auditor General's (Duties, Power and Conditions of Services) Act, 1971, prescribes that the C&AG shall hold office for a term of six years or upto the age of 65 years, whichever is earlier. He can resign at any time through a resignation letter addressed to the President. The Act also assigns the duties regarding the audit to be followed by C&AG.

The number of organisations subject to the audit of the Comptroller and Auditor General of India is very large. This includes:



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As a result of these numerous audits carried out every year, the Comptroller and Auditor General of India has been issuing a large number of audit reports.

Audit of Government Companies (Commercial Audit) – There is a special arrangement for the audit of companies where the equity participation by Government is 51 percent or more. The auditors of these companies are firms of Chartered Accountants, appointed by the Comptroller & Auditor General, who gives the auditor directions on the manner in which the audit should be conducted by them. He is also empowered to comment upon the audit reports of the auditors. In addition, he has a right to conduct a **supplementary audit** of such companies and cause **test audit** if considered necessary, by an order.

Audit Board Setup in Commercial Audit – A unique feature of the audit conducted by the Indian Audit and Accounts Department is the constitution of Audit Boards for conducting comprehensive audit appraisals of the working of Public Sector Enterprises engaged in diverse sectors of the economy.

These Audit Boards associate with them experts in disciplines relevant to the appraisals. They discuss their findings and conclusions with the managements of the enterprises and their controlling ministries and departments of government to ascertain their view points before finalisation.

The results of such comprehensive appraisals are incorporated by the Comptroller and Auditor General in his reports.

These Audit Boards have no separate legal entity and work under the supervision and control of the Comptroller and Auditor General.

Action on Audit Reports – The scrutiny of the Annual Accounts and the Audit Reports thereon by the Parliament as a whole would be an arduous task, considering their diverse and specialised nature, besides imposing excessive demands on the limited time available to the Parliament for discussion of issues of national importance.

Therefore, the Parliament and the State Legislatures have, for this purpose, constituted specialized Committees like the Public Accounts Committee (PAC), Estimates Committee and the Committee on Public Undertakings (COPU), to which these audit Reports and Annual Accounts automatically stand referred.

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Public Accounts Committee (PAC) – It is the duty of the Public Accounts Committee to satisfy itself:

(i) that the moneys were disbursed legally on the service or purpose to which they were applied;

(ii) that the expenditure incurred was authorised;

(iii) that re-appropriation has been made in accordance with the provisions made (i.e. distribution of funds).

It is also the duty of the PAC to examine the statement of accounts of autonomous and semi-autonomous bodies, the audit of which is conducted by the Comptroller & Auditor General either under the directions of the President or by a Statute of Parliament.

Estimates Committee – The Committee examines the estimates with a view to:

(i) report what economies, improvements in organization, efficiency or administrative reform, consistent with the policy underlying the estimates may be effected;

(ii) suggest alternative policies;

(iii) examine whether the money is well laid out within the limit; and

(iv) suggest the form in which the estimates shall be presented to Parliament.

The Committee does not comment upon a policy approved by Parliament, but where there is evidence that a particular policy is not leading to the desired results, or is leading to waste, it is the duty of the Committee to bring it to the notice of the House.

Committee on Public Undertakings (COPU) – The Committee on Public Undertakings exercises the same financial control on the public sector undertakings as the PAC exercises over the functioning of the Government departments. The functions of the Committee are -

(i) to examine the reports and accounts of public undertakings.

(ii) to examine the reports of the C&AG on public undertakings.

(iii) to examine the autonomy and efficiency of public undertakings and to see whether they are being managed in accordance with sound business principles and prudent commercial practices.

(iv) to exercise such other functions vested in the PAC and the Estimates Committee as are not covered above and as may be allotted by the Speaker from time to time.

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The examination of public enterprises by the Committee takes the form of comprehensive appraisal or evaluation of performance of the undertaking. It involves a thorough examination, including evaluation of the policies, programmes and financial working of the undertaking.

The objective of the Financial Committees, in doing so, is to focus not only on the individual irregularity, but also on the defects in the system which led to such irregularity, and the need for correction of such systems and procedures.

C&AG's Role – The Comptroller & Auditor General of India plays a key role in the functioning of the financial committees of Parliament and the State Legislatures. He has come to be recognised as a 'friend, philosopher and guide' of the Committees.

(i) His Reports generally form the basis of the Committees' working, although they are not precluded from examining issues not brought out in his Reports;

(ii) He scrutinises the notes which the Ministries submit to the Committees and helps the Committees to check the correctness of submissions to the Committees and facts and figures in their draft reports;

(iv) The Financial Committees present their Report to the Parliament/ State Legislature with their observations and recommendations.

The various Ministries / Department of the Government are required to inform the Committees of the action taken by them on the recommendations of the Committees (which are generally accepted) and the Committees present Action Taken Reports to Parliament / Legislature;

(v) In respect of those Audit Reports, which could not be discussed in detail by the Committees, written answers are obtained from the Department / Ministry concerned and are sometimes incorporated in the Reports presented to the Parliament / State Legislature.

This ensures that the Audit Reports are not taken lightly by the Government, even if the entire report is not deliberated upon by the Committee.

TEST YOUR UNDERSTANDING 1

PGC & Associates are statutory auditors of BNPC Limited, a PSU in power sector. It is engaged in building large sized thermal power stations to accelerate development of power sector in the country. One of the financial committees of Parliament has decided to examine its physical and financial performance. It has also examined the audit findings of C&AG in respect of which action is yet to be

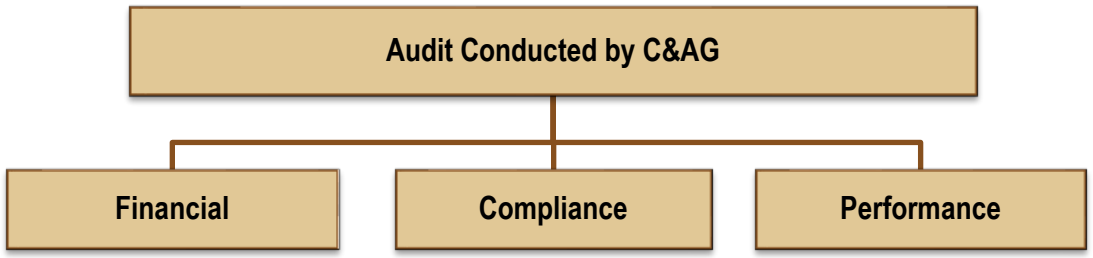
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taken by the said PSU. The committee also proposes to include in its report the performance of the company in various operational matters.

Which financial committee of Parliament deals with such matters? Outline its main functions.

3. OBJECTIVE AND SCOPE OF PUBLIC ENTERPRISES AUDIT

The C&AG's (Duties, Power and Conditions of Services) Act, 1971 specifies the entities that come under audit purview of C&AG at the Union and State level. However, the scope and extent of audit is determined by the C&AG itself.



(1) **Audit of PSUs not constrained to Financial and Compliance Audit:** Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to performance *(efficiency, economy and effectiveness with which these operate and fulfill their objectives and goals)*.

(2) **Propriety Audit:** Another aspect of audit relates to questions of propriety. This audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety.

(3) **Comprehensive Audit:** Under comprehensive audit, the C&AG do not really cover again the field which has already been covered. He conducts an appraisal or an efficiency-cum-performance audit. He sees whether the undertakings have fulfilled the objectives for which they have been established, whether value-for-money spent has been obtained, whether the targets have been achieved, etc. He locates the areas of weakness including review of the decisions taken by the management and a comprehensive appraisal of the performance of the undertaking.

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(4) **Organisation's Decision to be taken by Competent Authority:** In examining the decisions of a management, the auditor examines that these were taken by the competent authority after examination of all aspects (economic, technological, public interest) on the basis of all the relevant information available at that time and taking into consideration the different alternatives available to management and that the decisions were consistent with the aims and objectives of the enterprise.

(5) **Helping Government:** Audit is an instrument of accountability. But an equally important purpose of audit of public enterprises in India is to help the Government and the enterprise managements improve their efficiency and effectiveness. This is achieved by bringing out financial and operational deficiencies, inadequacies or ineffectiveness of systems, shortfalls in performance, etc. and by analysing the causes of shortfall from acceptable standards of performance.

(6) **Highlighting Issues of Efficient and Economic Operations:** Financial performance is linked with physical performance and issues of efficient and economic operations and management of resources are highlighted. There is an increasing emphasis on audit being an instrument of improvement.

(7) **Fiscal and Managerial Accountability:** In the broader context, Government audit encompasses **two main elements,** viz., (a) **Fiscal Accountability:** It includes audit of provisions of funds, sanctions, compliances and propriety; and (b) **Managerial Accountability:** It includes audit of efficiency, economy and effectiveness (This is often referred to as **efficiency-cum-performance audit**).

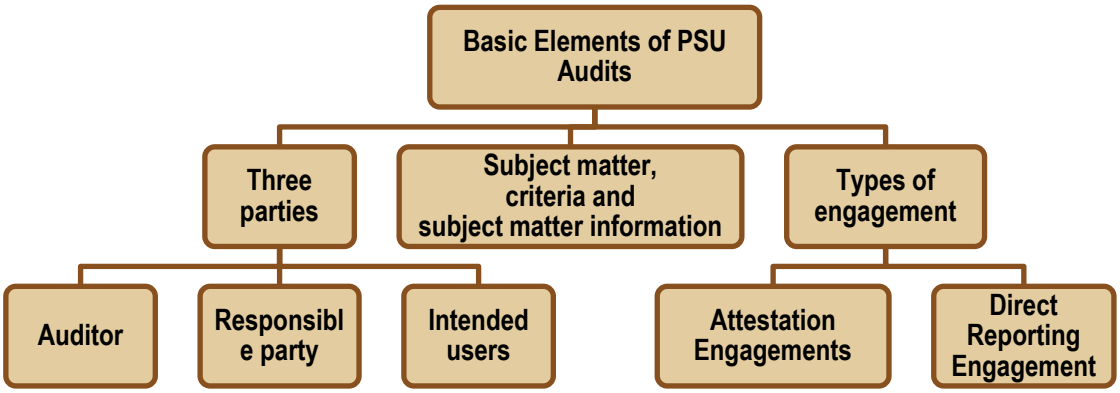
Efficiency- cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater efficiency , economy, and effectiveness.

3.1 Elements of PSU Audits

Public sector auditing augments the confidence of the intended users by providing relevant information and independent and objective assessments concerning deviations from accepted standards or principles of good governance.

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Audit of all public-sector undertakings have the following basic elements:



(a) The Three parties - Auditor, Responsible Party and Intended Users.

Auditor: The role of auditor is fulfilled by Supreme Audit Institution (SAI), India and by its personnel delegated with the duty of conducting audits. The Comptroller and Auditor General of India (C&AG) and the Indian Audit and Accounts Department (IAAD) functioning under him, constitute the Supreme Audit Institution of India. Senior functionaries of the SAI representing the C&AG in the state are called Accountants General.

Responsible Party: The relevant responsibilities are determined by constitutional or legislative arrangement. Generally, auditable entities and those charged with governance of the auditable entities would be the responsible parties. The responsible parties may be responsible for the subject matter information, for managing the subject matter or for addressing recommendations.

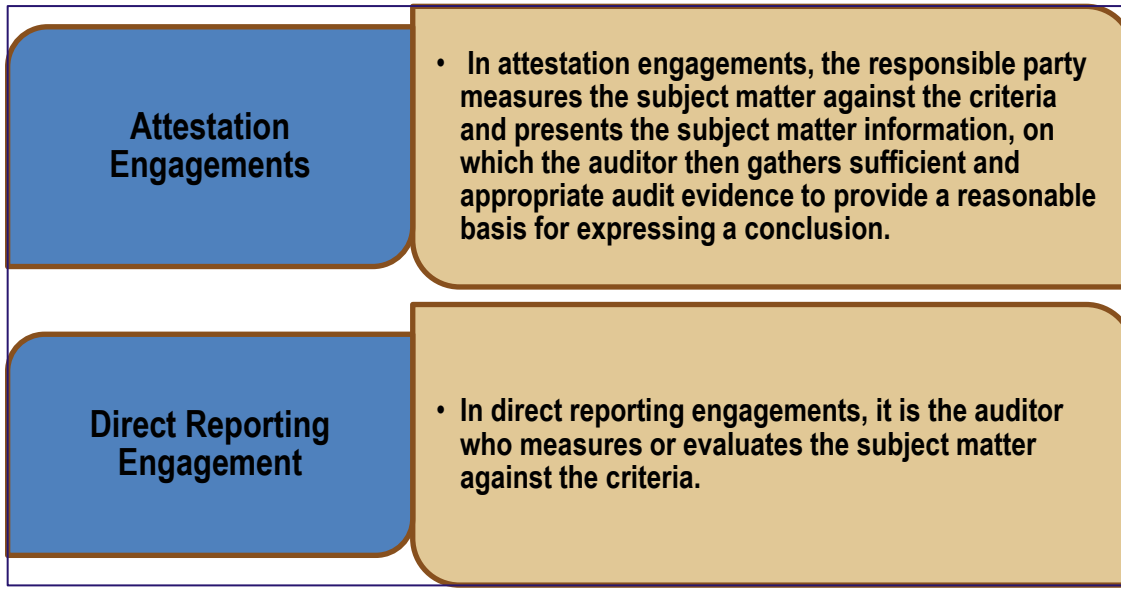
Intended Users: Intended users are the individuals, organizations or classes thereof for whom the auditor prepares the audit report.

(b) Subject matter, criteria and subject matter information.

Subject matter	• This refers to the information, condition or activity that is measured or evaluated against certain criteria.
Criteria	• These are the benchmarks used to evaluate the subject matter.
Subject matter information	• This refers to the outcome of evaluating or measuring the subject matter against the criteria.

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(c) Types of engagement - Attestation Engagements and Direct Reporting Engagement.



Financial audits are always **attestation engagements**, as they are based on financial information presented by the responsible party.

Performance audits and compliance audits are generally **direct reporting engagements**.

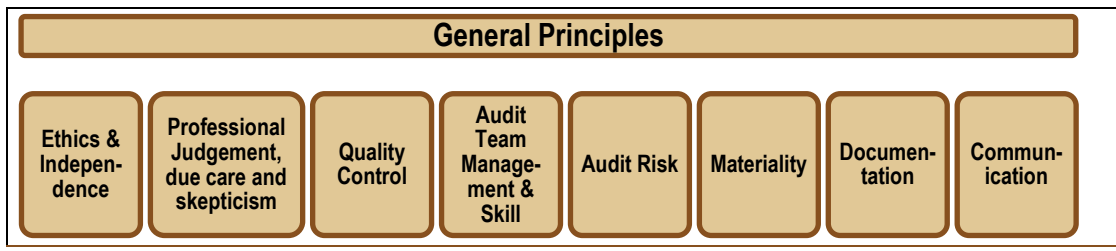
3.2 Principles of PSU Audits

The principles of PSU Audits constitute the general standards that apply to SAI India's personnel as auditors and are fundamental to the conduct of all types of PSU Audits.

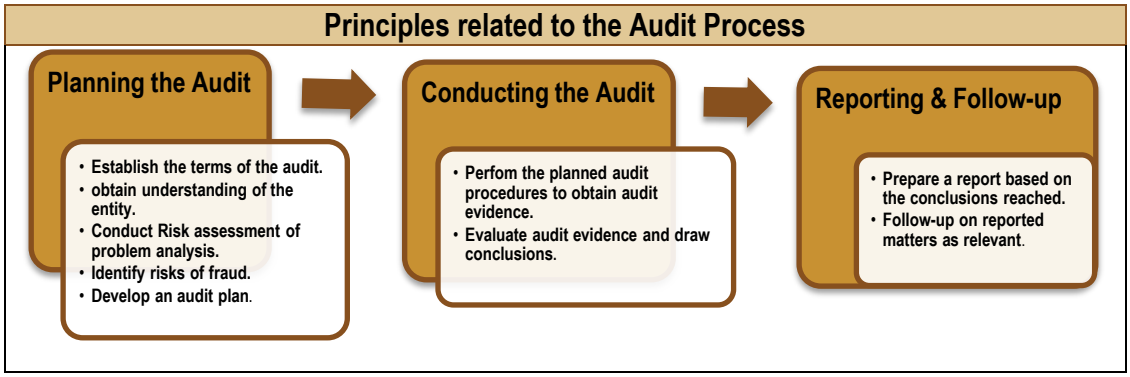
The principles are categorized into two distinct groups as below:

I. General Principles

II. Principles related to the Audit Process



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4. FINANCIAL AUDIT

Financial audit is primarily conducted to:

- **express an audit opinion on the financial statements; and**
- **enhance the degree of confidence of intended users in the financial statements.**

The C&AG shall express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In the case of financial statements prepared in accordance with a fair presentation financial reporting framework, whether the financial statements are presented fairly, in all material respects, or give a true and fair view, in accordance with that framework.

5. COMPLIANCE AUDIT

Compliance audit is the independent assessment of whether a given subject matter is in compliance with the applicable criteria.

This audit is carried out by assessing whether activities, financial transactions and information comply in all material respects, with the regulatory and other rules which govern the audited entity.



Source :- info.cgcompliance.com

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Compliance auditing is concerned with:

(a) **Regularity-** adherence of the subject matter to the formal criteria emanating from relevant laws, regulations and agreements applicable to the entity.

(b) **Propriety-** observance of the general principles governing sound financial management and the ethical conduct of public officials.

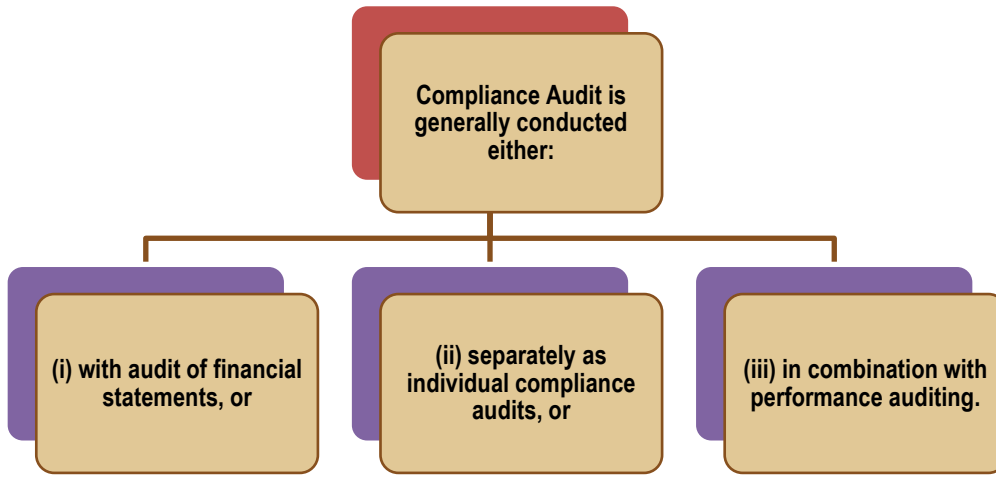
While regularity is emphasized in compliance auditing, propriety is equally pertinent in the public-sector context, in which there are certain expectations concerning financial management and the conduct of officials.

Perspective of Compliance Auditing: Compliance Auditing is part of a combined audit that may also include other aspects. Compliance auditing is generally conducted either-

(i) in relation with the audit of financial statements, or

(ii) separately as individual compliance audits, or

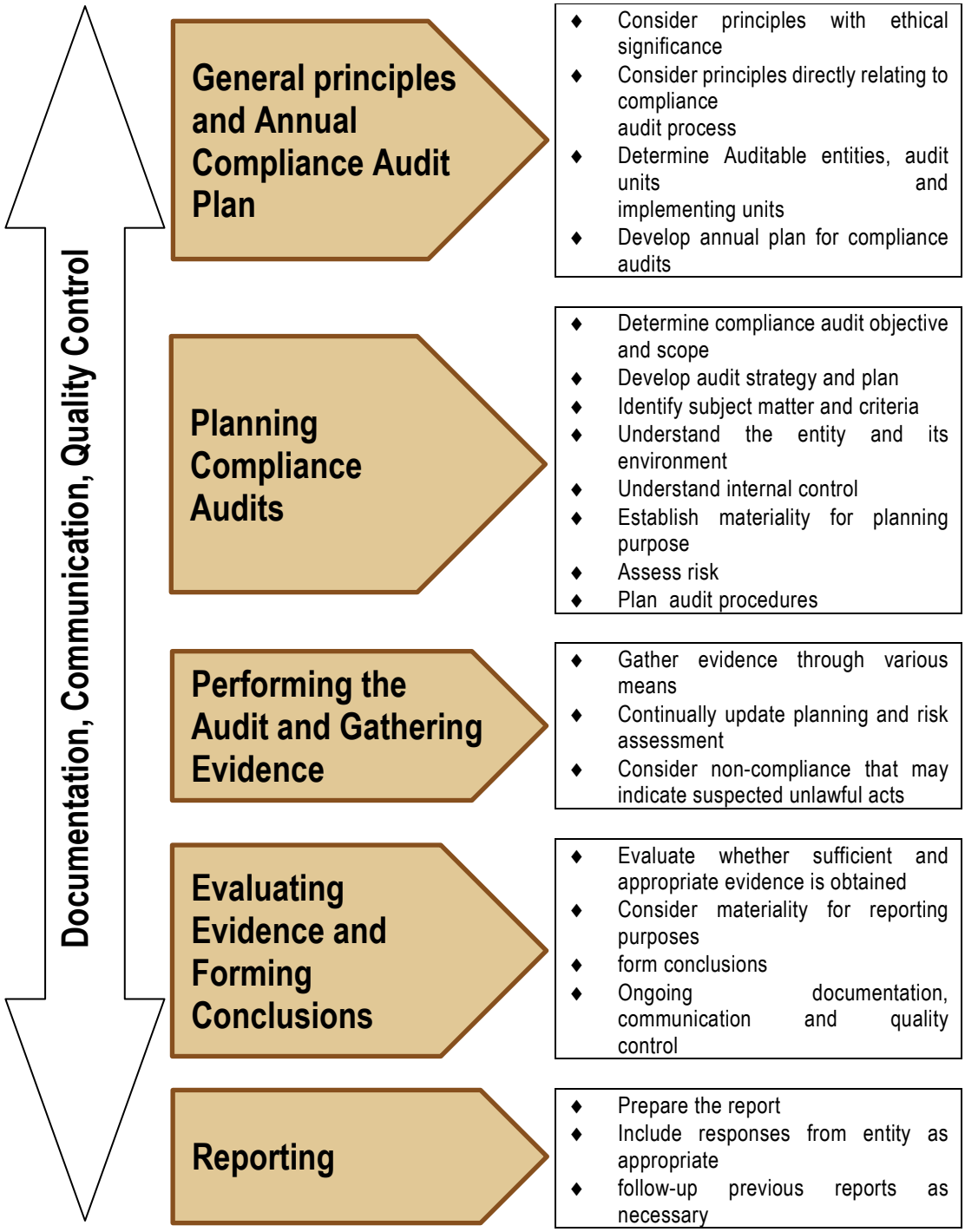
(iii) in combination with performance auditing.



When compliance auditing is part of a performance audit, compliance is seen as one of the aspects of economy, efficiency and effectiveness. Noncompliance may be the cause of, an explanation for, or a consequence of the state of the activities that are the subject matter of the performance audit.

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COMPLIANCE AUDIT PROCESS



(Source:- Compliance & Auditing Guidelines – C&AG of India)

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6. PERFORMANCE AUDIT

A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

Performance audit in PSUs is conducted by the C&AG (Supreme Audit Institutions) through various subordinate offices of Indian Audit and Accounts Department (IAAD).

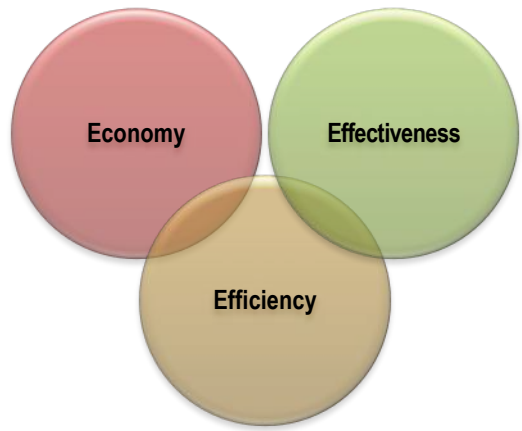
In conducting performance audit, the subordinate offices are guided by manual and auditing standards prescribed by C&AG.

This audit promotes accountability by assisting those charged with governance and oversight responsibilities to improve performance through an examination of whether:

(a) decisions by the legislature or the executive are efficiently and effectively prepared and implemented; and

(b) tax payers or citizens have received value for money.

According to the guidelines issued by the C&AG, Performance Audits usually address the issues of:



(i) Economy- It is minimising the cost of resources used for an activity, having regard to appropriate quantity, quality and at the best price.

Judging economy implies forming an opinion on the resources (**e.g. human, financial and material**) deployed. This requires assessing whether the given resources have been used economically and acquired in due time, in appropriate quantity and quality at the best price.

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When conducting audits of economy, the auditor may provide answers to such questions as: (ECA Performance Audit Manual , 2017)

- Have the best prices been obtained for consultancy services?
- Is there potential for reducing the cost of sickness absences?
- Are there procedures in place to ensure that transport costs of food aid are the lowest available?
- Has there been a waste of resources in achieving an output?

(ii) **Efficiency**- It is the input-output ratio. In the case of public spending, efficiency is achieved when the output is maximised at the minimum of inputs, or input is minimised for any given quantity and quality of output. When the audit objective of efficiency considers outputs, focus is usually on processes by which an organisation transforms inputs into outputs.

Auditing efficiency embraces aspects such as whether:

(a) sound procurement practices are followed;

(b) resources are properly protected and maintained;

(c) human, financial and other resources are efficiently used;

(d) optimum amount of resources (staff, equipment, and facilities) are used in producing or delivering the appropriate quantity and quality of goods or services in a timely manner;

(e) public sector programmes, entities and activities are efficiently managed, regulated, organised and executed;

(f) efficient operating procedures are used; and

(g) the objectives of public sector programmes are met cost-effectively.



In audits of efficiency, you might ask questions such as: How does the cost per job created by a training programme for the unemployed compare with similar costs per job elsewhere?

- Could project X have been implemented differently that would have resulted in improved timeliness and quality?
- Are adequate procedures and criteria for prioritising and selecting transport infrastructure projects to ensure maximum impact in place?
- Are schools maximising the use of their information technology equipment?

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- When the audit objective of efficiency considers outputs, you will usually focus on processes by which an organisation transforms inputs into outputs. **(Source : ECA Performance Audit Manual , 2017)**

(iii) **Effectiveness-** It is the extent to which objectives are achieved and the relationship between the intended impact and the actual impact of an activity.

In auditing effectiveness, performance audit may, for instance:

(a) assess whether the objectives of and the means provided (legal, financial, etc.) for a new or ongoing public sector programme are proper, consistent, suitable or relevant to the policy;

(b) determine the extent to which a program achieves a desired level of program results;

(c) assess and establish with evidence whether the observed direct or indirect social and economic impacts of a policy are due to implementation of the policy or to other causes;

(d) identify factors inhibiting satisfactory performance or goal-fulfilment;

(e) assess whether the programme complements, duplicates, overlaps or counteracts other related programmes;

(f) assess the effectiveness of the program and/or of individual program components;

(g) determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;

(h) assess the adequacy of the management control system for measuring, monitoring and reporting a programme's effectiveness;

(i) assess compliance with laws and regulations applicable to the program; and

(j) identify ways of making programmes work more effectively.



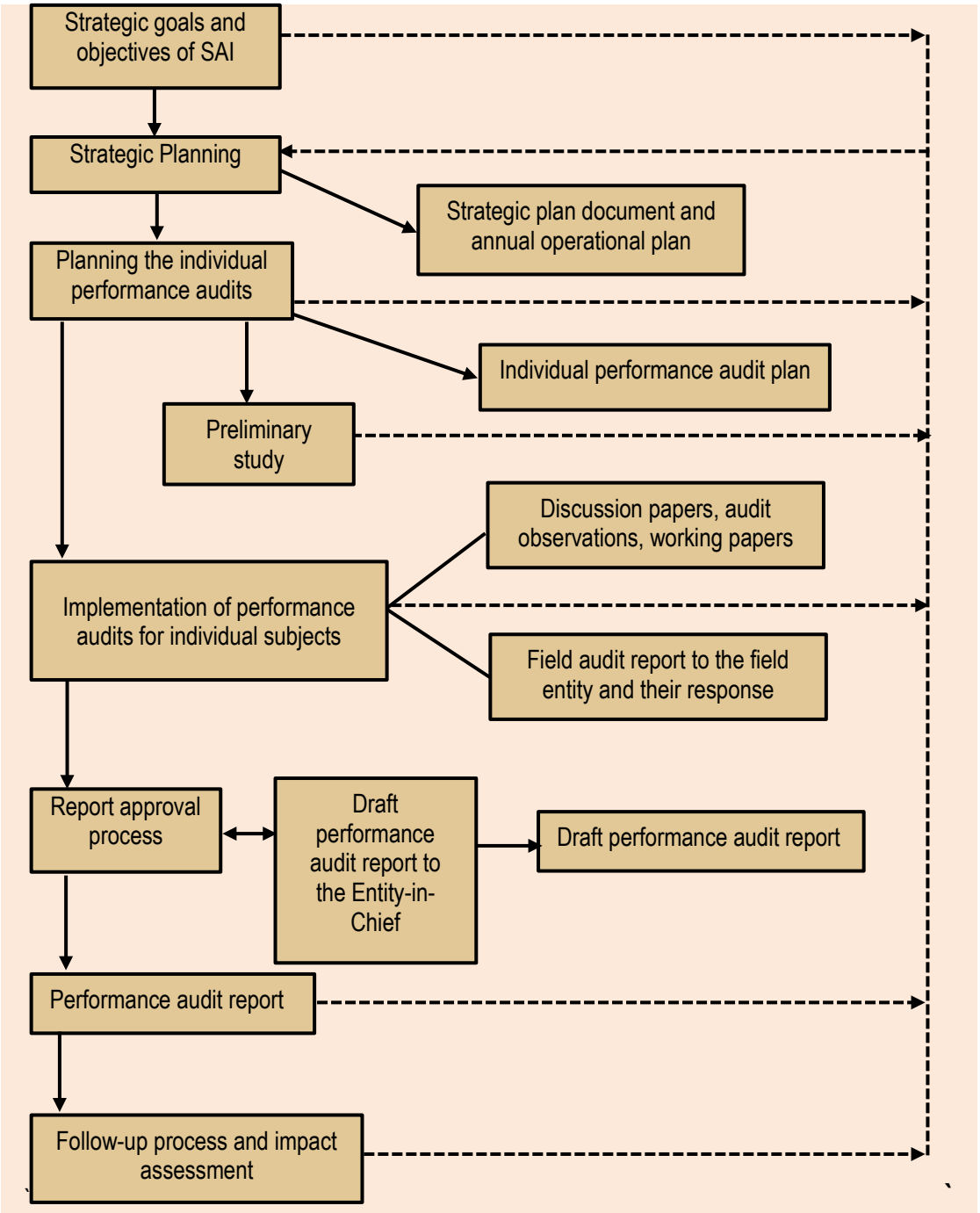
It focuses on questions such as:

- *Have infrastructure projects contributed to increased traffic flow while improving safety and reducing journey times?*
- *Have suitable measures to monitor and mitigate the environmental impact in sector X been set up and properly implemented?*
- *Are departments or entities achieving their objectives for all sectors of the community?*

(Source : ECA Performance Audit Manual,2017)

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Performance Audit Cycle



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6.1 Objectives of Performance Audit

The objectives of performance auditing are evaluation of economy, efficiency, and effectiveness of policy, programmes, organization and management. It also promotes accountability by assisting those charged with governance and oversight responsibilities to improve performance; and transparency by affording taxpayers, those targeted by government policies and other stakeholders an insight into the management and outcomes of different government activities.

Performance auditing focuses on areas in which it can add value which have the greatest potential for development. It provides constructive incentives for the responsible parties to take appropriate action.

Regulations on Audit and Accounts issued by C&AG lay down that the responsibility for the development of measurable objectives and performance indicators as also the systems of measurement rests with the Government departments or Heads of entities. They are also required to define intermediate and final outputs and outcomes in measurable and monitorable terms, standardise the unit cost of delivery and benchmark quality of outputs and outcomes.



1. Performance Audit of enforcement mechanism for administering the provision of Minimum Wages Act (a social welfare legislation)

The auditors, who undertake performance audit of a program or unit, must possess knowledge of the industries or labor contracts where these provisions are applicable and also identify the population thereof before carrying out audit program. He shall evaluate the standard of living before implementation and after implementation of the Act.

Further, the auditor shall have to evaluate the evidence available as to nature of returns prescribed and obtained for taking appropriate action.

The Performance Auditor shall also have to evaluate the economy, efficiency and effectiveness in the welfare systems to be audited. He can then study the shortcomings in the coordination between different agencies like labor department, EPF and ESI organization and the control systems and point out a set of relevant problems.

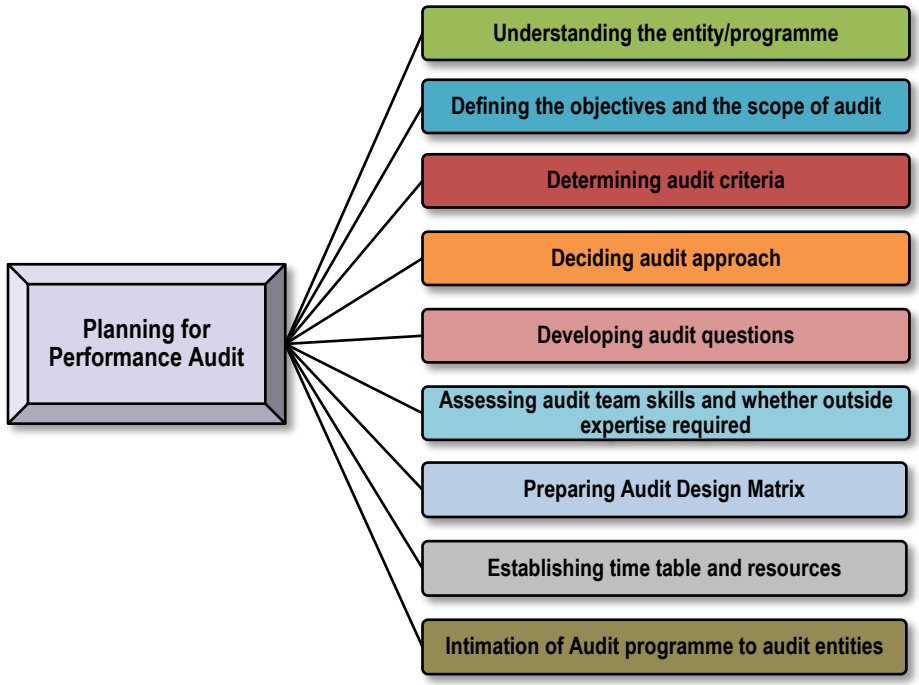
The auditor shall also have to point out lacuna, if any in the existing legal frame work or enforcement mechanism to strengthen the objective of legislation. Another possible area of critical audit may be to study actual level of compensation required in each area keeping in mind the local living conditions and where the minimum wages prescribed in the statute is demonstrably different from this level he may report the same to the Government for taking appropriate action.

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In this manner, the performance audit can not only examine the reasons for such vagaries but also ensures that the legislation serves the intended purpose. By reporting the same to the legislature, the corrective is made possible.

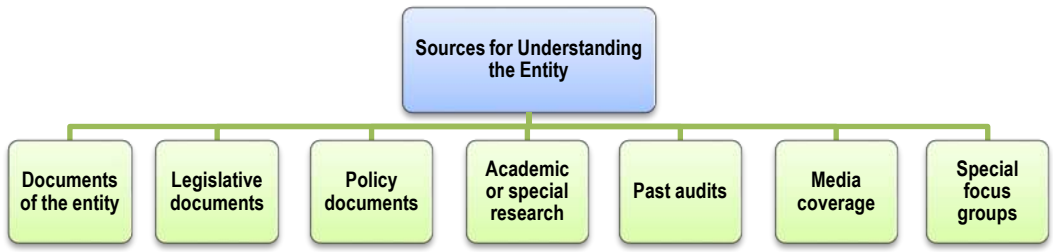
[**Note:** Interested students may refer to Background Material on Performance Audit of Public Sector Enterprises in India published by the CPE Committee of ICAI for further reference].

6.2 Planning for Performance Audit



The following steps are suggested to the auditors for planning while conducting the performance audit:

(A) Understanding the Entity/Programme - It is the starting point for planning individual performance audit.



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The auditor may use the following sources for understanding the entity:

(i) **Documents of the entity:** Documents on administration and functions of the entity, policy files, annual reports, budget documents, accounts, minutes of meetings, information on the website, internal audit reports, electronic databases and MIS reports, RTI material etc.

(ii) **Legislative documents:** Legislation, parliamentary questions and debates, reports of the Public Accounts Committee, the Committee on Public Undertakings, the Estimates Committee and letters from Members of Parliament.

(iii) **Policy documents:** Documents of Planning Commission, Ministry of Finance etc.

(iv) **Academic or special research:** Independent evaluations on the entity, academic research and similar work done by other governments and other SAIs.

(v) **Past audits:** Past financial and performance audits of the entity provide a major source of information and understanding.

(vi) **Media coverage:** Print and electronic media - their systematic documentation on regular basis in a transparent manner.

(vii) **Special focus groups:** Audit Advisory Committee concerns, annual and special reports of World Bank, Reserve Bank of India, reports by special interest groups, NGOs, etc.

(B) Defining the Objectives and the Scope of Audit - The audit objectives should be defined in a crisp & clear manner as they will impact the nature of the audit, govern its conduct and affect audit conclusions. Setting audit objectives ensures good quality performance audits. It facilitates clarity, demonstrates consistent quality of audit and serves as a measure of quality assurance of the audit.

Defining the scope constricts the audit to significant issues that relate to the audit objectives. It mainly focuses on the extent, timing and nature of the audit.

(C) Determining Audit Criteria - Audit criteria are the standards used to determine whether a program meets or exceeds expectations. It provides a context for understanding the results of the audit. Audit criteria are reasonable and attainable standards of performance against which economy, efficiency and effectiveness of programmes and activities can be assessed.

The audit criteria may be sought to be obtained from the following sources:

(i) procedure manuals of the entity.

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(ii) policies, standards, directives and guidelines.

(iii) criteria used by the same entity or other entities in similar activities or programmes.

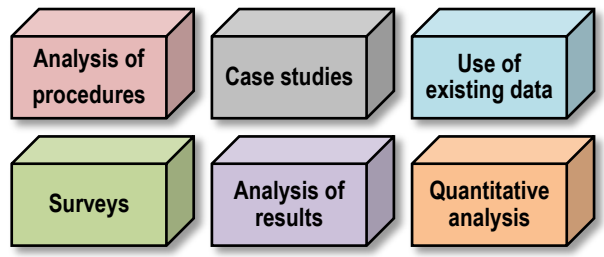
(iv) independent expert opinion and know how.

(v) new or established scientific knowledge and other reliable information.

(vi) general management and subject matter literature and research papers.

(D) Deciding Audit Approach - There is no uniform audit approach prescribed that can be applicable to all types of subjects of performance audits. Selection of approach also determine methods and means used for conducting the audit.

Some of the methods which could be used in conducting performance audits include:



(i) Analysis of procedures: It involves review of the systems in place for planning, conducting, checking and monitoring the activity. This would consist of examination of documents such as financial reports, budgets, programme guidelines, procedure manuals, etc.

(ii) Case studies: A case study is a descriptive analysis of an entity, scheme or a programme. It involves analysis of a particular issue within the context of the whole area under review.

(iii) Use of existing data: The audit staff should investigate the data held by entity management and by other relevant sources. Audit conclusions based on testing of available data for correctness and completeness enhances the assurance level.

(iv) Surveys: Survey is a method of collecting information from members of a population to assess the interrelation of events and conditions. Surveys on predetermined parameters can supplement the audit findings and conclusions adding value to the performance audits.

(v) Analysis of results: It requires the auditor to carry out actual output-input analysis to determine the efficiency of the programme.

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(vi) **Quantitative analysis:** It involves examination of available data relating to financials like earnings, revenue, or data relating to programme implementation like details of beneficiaries etc. However, it may not be possible for the auditor to work with complete data due to its high volume. In such cases, sampling techniques are required to be used.

(E) Developing Audit Questions - Subsequent to designing of audit objectives and determination of audit criteria, the audit team is required to prepare a list of questions to which they would seek answers. The questions should be framed in comprehensive manner involving detailed hierarchy of questions.

(F) Assessing Audit Team Skills and whether Outside Expertise required - It is essential that the performance auditors possess special aptitude and knowledge. The Auditing Standards of C&AG of India provide that the audit institution should develop and train the auditors to enable them to perform their tasks effectively & efficiently and should prepare manuals & other written guidance notes & instructions concerning conduct of audits.

Given the diverse range of subjects of performance auditing, the audit team needs to develop sound understanding of the programme or entity proposed to be audited.

The audit team needs to decide at the planning stage on which aspect expertise is required. Though, the Accountant General may use the work of an expert, he retains full responsibility for the expression of opinion in the auditor's report.

(G) Preparing Audit Design Matrix (ADM) - Having determined the audit objective, audit criteria, audit approach, data collection etc., audit team should prepare an Audit Design Matrix. It is a structured and highly focused approach to designing a performance audit study.

The ADM highlights the data collection and analysis method as well as the type and sources of evidence required to support audit opinion/findings.

A specimen of ADM is given as under:

Audit Objective (1)	Audit Questions (2)	Audit Criteria (3)	Evidence (4)	Data Collection and Analysis Method (5)

An ADM is prepared on the basis of information and knowledge obtained during the planning stage. A well-designed ADM leads to effective audits thus providing highest assurances to the auditing entities. It is desirable to prepare ADM for each of the audit objectives.

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(H) **Establishing Time Table and Resources** - It is significant to determine the timetable and desirable resources. Selection of appropriate audit team is the most vital component in planning an audit. Considerations for selection of an appropriate audit team should be recorded along with the proposed timelines for various activities to be undertaken as a part of audit process. The progress should also be monitored against these timelines. The Accountant General would be liable for ensuring that the performance audit is completed on time. The variations between the required and actual time spent should be compared and approved from the competent authority.

The team should build time for translation, approval and possible delays in their own schedule in order to meet the targets.

(I) **Intimation of Audit Programme to Audit Entities -** Audited entities must be intimated about the intention of taking up planned performance audit with the scope and extent of audit including the constitution of audit team and the tentative time schedule, well before the commencement of Audit. Acknowledgement of this may be requested and placed on record.

It may be required to refine an audit's objectives as the audit progresses for gathering the requisite information to fulfill the audit. The reasons for such changes in the objectives should also be recorded and approved from the competent authority.

The audit programme should be flexible and reviewed from time to time as it is not possible to anticipate all the contingencies at the early stage.

The Accountant General should share all significant refinements in the approach and additional tests and findings, concurrently with other audit teams when different persons conduct the audit at different locations. The system of sharing of the significant field audit experience should be documented and reviewed.

Illustration

The objectives of audit in connection with a State Electricity Distribution Company were to ascertain whether the:

(i) **total cost of providing electricity is being recovered by timely submissions to the State Electricity Regulatory Commission;**

(ii) **tariff orders, sales circulars and sales instructions were issued timely, without any ambiguity. They were implemented in time;**

(iii) **metering, billing and collection was managed efficiently and effectively;**

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(iv) monitoring and internal controls were efficient.

What kind of audit is this? Prepare two sample observations which could be part of the audit report.

This is a performance audit. Sample observations could be:

(i) Non replacement of defective/ burnt meters: Large number of meters, much in excess of the permitted limit of 1% of the total meters were defective and their replacement was not completed within the stipulated time of 1 month. This resulted in billing on average basis for a continuous period of several months. This could result in losses as well as administrative hassles and disputes with consumers.

(ii) Under charging of meter rent: As per Schedule of Charges, the Company is required to charge meter rent of ₹30 per month for a single phase meter and ₹40 per month for three phase meter. It was observed that the Company had short charged meter rent of ₹60 lakh from 3 lakh consumers in 5 lakh bills during the period.

7. COMPREHENSIVE AUDIT

The Comptroller and Auditor General assists the legislature in reviewing the performance of public undertakings. He conducts an efficiency-cum-performance audit other than the field which has already been covered either by the internal audit of the individual concerns or by the professional auditors. He locates the area of weakness and extravagance for managements' information.

The areas covered in comprehensive audit naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. The auditors combine aspects of Financial , Compliance and Performance audits. All the audit information is used in such a way that a holistic assessment is possible. However, in general, the covered areas are those of investment decisions, project formulation, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, materials management, sales and credit control, budgetary and internal control systems, etc.

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Some of the issues examined in comprehensive audit are:

(a) How does the overall capital cost of the project compare with the approved planned costs? Were there any substantial increases and, if so, what are these and whether there is evidence of extravagance or unnecessary expenditure?

(b) Have the planned production or operational outputs been achieved? Has there been under-utilisation of installed capacity or shortfall in performance and, if so, what has caused it?

(c) Has the planned rate of return been achieved?

(d) Are the systems of project formulation and execution sound? Are there inadequacies? What has been the effect on the gestation period and capital cost?

(e) Are cost control measures adequate and are there inefficiencies, wastages in raw materials consumption, etc.?

(f) Are the purchase policies adequate? Or have they led to piling up of inventory resulting in redundancy in stores and spares?

(g) Does the enterprise have research and development programmes? What has been the performance in adopting new processes, technologies, improving profits and in reducing costs through technological progress?

(h) If the enterprise has an adequate system of repairs and maintenance?

(i) Are procedures effective and economical?

(j) Is there any poor or insufficient or inefficient project planning?

The Bureau of Public Enterprises has issued guidelines to be followed by the public sector enterprises in respect of general management, financial management, materials management, production management, construction management, etc. and these guidelines provide another basis for appraising enterprise performance and its systems. Another source of criteria is industrial engineering and other technical studies by internal and external experts and the standards given in these. Then there are standards of financial propriety.

The starting point of a comprehensive appraisal of a public enterprise, which covers aspects of economy, efficiency and effectiveness, is the preparation of an audit programme based on the study of decisions relating to the setting up of the enterprise, its objectives, the areas of operation, organisation, financial and operational details available in the annual reports and accounts, capital and operational budgets, deliberations of the board of directors, material in the earlier audit

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inspection reports on the enterprise and other relevant available papers. These audit programmes (or guidelines) identify the areas/aspects which require further detailed audit analysis and criteria, the data required for such analysis and the sources of such data, the extent of the audit analysis including the test checks to be applied and the instructions to the audit parties assigned to the work.

TEST YOUR UNDERSTANDING 2

PS & Associates are statutory auditors of a Central Government owned company for a particular year. The statutory auditors were required to examine the following areas mandatorily, provide their specific replies and also their impact on financial statements for that particular year in their audit report.

1. Whether the company has system in place to process all the accounting transactions through IT system? If yes, the implications of processing accounting transactions outside IT system on the integrity of the accounts along with the financial implications, if any, may be stated.

2. Whether there is any restructuring of an existing loan or cases of waiver / write-off of debts / loans/ interest etc. made by a lender to the company due to the company's inability to repay the loan? If yes, the financial impact may be stated. Whether such cases are properly accounted for?

3. Whether funds (grants/subsidy etc.) received / receivable for specific schemes from Central Government or its agencies were properly accounted for / utilized as per its term and conditions? List the cases of deviation.

Can you determine the likely nature of such responsibility thrust upon auditors of above PSU?



8. PROPRIETY AUDIT

Auditing, as a composite concept, looks into accounting and arithmetical accuracy, adherence to applicable rules and regulations, propriety and the ''truth and fairness'' of the end result. According to the varied requirements, the emphasis on each of the aforesaid factors differs between various types of audit. Propriety aspects in an audit already exists in the audits carried on by the C&AG.

8.1 Definition and Principles

Propriety audit stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct.

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E.L. Kohler has defined the term propriety as "that which meets the tests of public interest, commonly accepted customs, and standards of conduct, and particularly as applied to professional performance, requirements of law, Government regulations and professional codes".

On an analysis, the tests boil down to tests on economy, efficiency and faithfulness. Instead of too much dependence on documents, vouchers and evidence, it shifts the emphasis to the substance of transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure.

Thus, propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company, with special regard to public interest and commonly accepted customs and standards of conduct. It is also seen whether every officer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances.

In 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. A transaction may satisfy all the requirements of regularity audit in so far 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 infructuous expenditure or a school building may be constructed but used after five years of its completion is a case of avoidable expenditure.

Audit should, therefore, try to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions. These considerations have led to the evolution of audit against propriety which is now being combined by the audit authorities with their routine function of regularity audit. It is hard to frame any precise rules for regulating the course of audit against propriety. Such an objective of audit depends for its acceptance on its appeal to the common sense and straight logic of the auditors and of those whose financial transactions are subjected to propriety audit. However, some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety.

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Propriety requires the transactions, and more particularly expenditure, to conform to certain general principles. These principles are:

(i) that the expenditure is not *prima facie* more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence would exercise in respect of his own money;

(ii) that the authority exercises its power of sanctioning expenditure to pass an order which will not directly or indirectly accrue to its own advantage;

(iii) that funds are not utilised for the benefit of a particular person or group of persons and

(iv) that, apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

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.

The functions of Auditor in the context of Propriety Audit may be specified as under as to :

- see that all expenditure incurred are properly planned.
- see that the size and channels of expenditure are rightful and expected to give maximum results.
- appraise whether those expenditure are likely to give optimum result.
- see that any substitute plan of action can bring about an improvement on current operation and as well as return from capital expenditure.
- examine the actions and decisions of the management to see that they are conductive to public interests and that they meet the standards of conduct.

Propriety Audit-Issues: Problems in propriety audit, however, arise mainly because of its distinct nature. The expression "propriety" is a moral term and can be understood by reference to the concept of morality accepted by the society at a given time. In any auditing, the essential test lies in formulation of auditing propositions. In the audit of financial accounts by reference to financial and legal requirements, propositions are built up about happening of events, existence, accuracy, title, ownership, compliance with law and internal regulations etc., which are all verifiable. In propriety audit the formulation of verifiable auditing propositions poses the problem.

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Propriety audit has an inherent element of subjectivity because it is very difficult to establish standards of public interest, commonly accepted customs, standards for conduct which are not firm basis for audit evaluation. To take care of this situation, the C&AG has developed the norms of propriety for expenditure of public funds in our country. By laying down the standards of propriety for Government expenditure the C&AG has really tried to tackle in a practical way the complex problem of subjectivity inherent in a situation calling for propriety consideration.

The norms so developed provide the basis of verifying expenditure incurred by various Government departments. It may be appreciated that the norms of propriety applicable to governmental transactions may not *ipso facto* apply to transactions of private sector which have distinct and more limited, objectives suited to them. Each private sector entity may have its unique objectives related, to its management philosophy and the transactions should be geared to achieve those. **For example,** a management which is operating for maximization of profits without infringing, any legal regulations may follow certain policies while another management believing in a wider measure of social justice may follow different policies. Despite these clear angularities, certain commonness can also be discerned in the policies and approaches of different managements. They include efficient operations, higher productivity and higher profit, reduction of wasteful expenditure etc. Above all, each entity has its impact on the society and building up propriety audit propositions becomes of paramount importance.

It is felt that if the management of each entity, irrespective of any legal requirements, formulates norms of propriety for the entity, taking full note of wider social repercussions inherent in its operations; a formidable hurdle in the way of wider introduction of propriety audit can be removed. The element of subjectivity in propriety evaluation will get reduced.

Propriety as a moral element should be a matter of evaluation based on objectives and prevailing circumstances. **For example**, a travel by air as such should not be considered wasteful unless it is proved that a travel by rail would have been feasible in the circumstances and would have brought the same results brought by the air travel.

The element of subjectivity has sometimes resulted in proper discharge of duty very delicate and which demands discretion, but wisdom of taking commercial decisions under dynamic environment (the economic, social and political) must be evaluated with reference to the circumstances in which these were taken (and not on hindsight) and therefore, the auditor in his field must reconstruct such circumstances. The judgment of the auditor must be objective as otherwise it would dampen the initiative of management and others in taking commercial decisions and propriety audit would prove itself to be counter productive.

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9. AUDIT REPORT OF THE COMPTROLLER AND AUDITOR GENERAL

To facilitate a proper consideration, the reports of the C&AG on the audit of PSUs are presented to the Parliament in several parts consisting of the following:

(a) Introduction containing a general review of the working results of Government companies, deemed Government companies and corporations;

(b) Results of comprehensive appraisals of selected undertakings conducted by the Audit Board;

(c) Resume of the company auditors' reports submitted by them under the directions issued by the C&AG and that of comments on the accounts of the Government companies; and

(d) Significant results of audit of the undertakings not taken up for appraisal by the Audit Board.

For certain specified states, the C&AG submits a separate audit report (commercial) to the legislature, while for other States/Union Territories with legislature, there is a commercial chapter in the main audit report. The State audit reports, contains both the results of audit appraisal of performance of selected companies/corporations as well as important individual instances of financial irregularities, wasteful expenditure, system deficiencies noticed by the statutory auditors, and a general review of the working results of Government companies and corporations.

Key Takeaways

- Public sector undertakings in India are fundamentally owned or controlled by Central Government, or any State Government or Governments, or partly by the Central Government and one or more State Governments. Such undertakings play a key role in the socio-economic development of the country.
- The accounts of selected government Companies along with the report of the statutory auditors are reviewed by C&AG by carrying out a supplementary audit.
- The scope and extent of audit carried out by C&AG in relation to PSUs may relate to compliance audit, financial audit and performance audit.
- Compliance audit is the independent assessment of whether a given subject matter is in compliance with the applicable criteria.
- Performance audit is an objective and systematic examination of evidence for providing an independent assessment of the performance of a government organization, program, activity

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or function in order to provide information to improve public accountability and facilitate decision making by parties with responsibilities to oversee or initiate corrective action.

- Performance audits usually address the issues of economy, efficiency and effectiveness.
- Comprehensive audit combines aspects of financial, compliance and performance audits. All the audit information is used in such a way that a holistic assessment is possible.
- In 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. A transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned, however, it may still be highly wasteful.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *The reports of the Comptroller and Auditor General of India on the audit of PSUs are presented to the Parliament and to various state legislatures to facilitate a proper consideration. Enumerate the contents of Audit Report presented by C & AG.*
2. *ABG & Co., a Chartered Accountant firm has been appointed by C & AG for performance audit of a Sugar Industry. What factors should be considered by ABG & Co., while planning a performance audit of Sugar Industry?*
3. *Sunlight Limited is a public sector undertaking engaged in production of electricity from solar power. It had commissioned a new project near Goa with a new technology for a cost of ₹ 5,750 crore. The project had seen delay in commencement and cost overrun. State the matters that a Comprehensive Audit by C&AG may cover in reporting on the performance and efficiency of this project.*
4. *"A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action." Briefly discuss the issues addressed by Performance Audits conducted in accordance with the guidelines issued by C&AG.*

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5. *BT Ltd., a company wholly owned by the Central Government was disinvested during the previous year, resulting in 40% of the shares being held by public. The shares were also listed on the BSE. Since the shares were listed, all the listing requirements were applicable, including publication of quarterly results, submission of information to the BSE etc.*

   Sam, the FM of the company is of the opinion that now the company is subject to stringent control by BSE and the markets, therefore the auditing requirements of a limited company in private sector under the Companies Act 2013 would be applicable to the company and the C&AG will not have any role to play. Comment.

6. *You have been appointed as auditor of a AKY Ltd. After having determined the audit objectives, now you have been requested to draft audit criteria. What are the sources that you will use while doing the task?*

7. *Comptroller & Auditor General appointed Verma & Associates, a chartered accountant firm, to conduct Performance audit of MAP Ltd., a public sector undertaking of Government of India. The firm conducted the audit with a view to check all the expenses of the unit are in conformity with the public interest and publicly accepted customs. The audit report submitted by audit firm was rejected by C&AG. Give your opinion on the action of C&AG.*

8. *The objectives of audit in connection with a State Electricity Distribution Company were to ascertain whether the:*

   (i) total cost of providing electricity is being recovered by timely submissions to the State Electricity Regulatory Commission;

   (ii) tariff orders, sales circulars and sales instructions were issued timely, without any ambiguity. They were implemented in time;

   (iii) metering, billing and collection was managed efficiently and effectively;

   (iv) monitoring and internal controls were efficient.

   What kind of audit is referred in the above scenario? Also briefly discuss the steps suggested to the auditors for planning such an audit.

9. **During the course of an audit of a state government department, the Office of the Comptroller & Auditor General of India (CAG) observed that the prescribed law in the state defined a "flat" based on the following two criteria in a premises:**

   - ***Dwelling units exceeding a threshold limit***
   - ***Buildings with a total area surpassing a threshold limit***

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However, it was noted during the audit that the relevant database did not include a column for entering the area of the building. Consequently, a certain number of buildings were identified as flats even though they had fewer dwelling units than the threshold limit. In the absence of data regarding the area, the audit team directed physical verification of these flats. The physical verification confirmed that these buildings were incorrectly classified as flats, resulting in the department undercollecting water charges.

Identify type and nature of audit being performed by Office of Comptroller & Auditor General of India. To whom report of such audit was likely to have been submitted.

10. ***Direct Benefit Transfer (DBT) is a major reform initiative of the Government of India to ensure better and timely delivery of benefits from Government to people. It marks a paradigm shift in the process of delivering benefits like wage payments, fuel subsidies, food grain subsidies, etc. directly into the bank accounts of the beneficiaries removing leakages and enhancing financial inclusion.***

The office of C & AG of India is likely to undertake a performance audit for a block of years in a state of some selected social security pension schemes and scholarship schemes under DBT. What are likely to be objectives of such performance audit? Explain the meaning of "audit criteria" and also discuss how these can be determined in above case.

Answers to Test Your Understanding

1. The said matters are dealt by Committee on Public Undertakings (COPU). The functions of the Committee are -

(i) to examine the reports and accounts of public undertakings.

(ii) to examine the reports of the C&AG on public undertakings.

(iii) to examine the autonomy and efficiency of public undertakings and to see whether they are being managed in accordance with sound business principles and prudent commercial practices.

(iv) to exercise such other functions vested in the PAC and the Estimates Committee as are not covered above and as may be allotted by the Speaker from time to time.

The examination of public enterprises by the Committee takes the form of comprehensive appraisal or evaluation of performance of the undertaking. It involves a thorough examination, including evaluation of the policies, programmes and financial working of the undertaking.

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2. The given areas for which statutory auditors of PSU were required to examine, report and indicate impact of these matters in financial statements are likely to relate to directions issued by C&AG to statutory auditors under section 143(5) of the Companies Act, 2013.

In terms of section 143(5), in case of a government company, the C&AG has the power to direct the auditor the manners in which accounts of company are required to be audited and auditor shall submit audit report which among other things, include the directions, if any, issued by the C&AG the action taken thereon and its impact on the accounts and financial statements of the company.

Hints /Answers to Theoretical Questions

1. Refer Para 9.

2. Factors to be considered while planning the Performance Audit: Refer Para 6.2.

3. Refer Para 7.

4. Refer Para 6.

5. Section 2(45) of the Companies Act, 2013, defines a "Government Company" as a company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company. The auditors of these government companies are firms of Chartered Accountants, appointed by the Comptroller & Auditor General, who gives the auditor directions on the manner in which the audit should be conducted by them. The listing of company's shares on a stock exchange is irrelevant for this purpose and hence Sam's opinion is not correct.

6. Refer Para 6.2.

7. In the given scenario, C&AG appointed Verma & Associates, a chartered accountant firm, to conduct Performance Audit of MAP Ltd., a PSU of Government of India. The firm conducted audit with a view to check all the expenses of the unit are in conformity to the public interest and publicly accepted customs which is not Performance Audit.

A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability

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and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

Performance audit in PSUs is conducted by the C&AG (Supreme Audit Institutions) through various subordinate offices of Indian Audit and Accounts Department (IAAD). In conducting performance audit, the subordinate offices are guided by manual and auditing standards prescribed by C&AG.

Therefore, the objectives of performance auditing are evaluation of economy, efficiency, and effectiveness of policy, programmes, organization and management. It also promotes accountability by assisting those charged with governance and oversight responsibilities to improve performance; and transparency by affording taxpayers, those targeted by government policies and other stakeholders an insight into the management and outcomes of different government activities.

Performance auditing focuses on areas in which it can add value which have the greatest potential for development. It provides constructive incentives for the responsible parties to take appropriate action.

Regulations on Audit and Accounts issued by C&AG lay down that the responsibility for the development of measurable objectives and performance indicators as also the systems of measurement rests with the Government departments or Heads of entities. They are also required to define intermediate and final outputs and outcomes in measurable and monitorable terms, standardise the unit cost of delivery and benchmark quality of outputs and outcomes.

Thus, rejection of audit report (submitted by audit firm) by C&AG is in order as audit with a view to mere check all the expenses of the unit are in conformity to the public interest and publicly accepted customs done by audit firm is not performance audit in all aspects.

8. In the given scenario, in view of the objectives discussed, performance audit is being referred. Refer Para 6.2.

9. In the given case, it is a "Compliance Audit" performed by Office of Comptroller & Auditor General of India.

Compliance audit is the independent assessment of whether a given subject matter is in compliance with the applicable criteria.

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This audit is carried out by assessing whether activities, financial transactions and information comply in all material respects with the regulatory and other rules which govern the audited entity. Compliance auditing is concerned with: -

(a) Regularity- adherence of the subject matter to the formal criteria emanating from relevant laws, regulations, and agreements applicable to the entity.

(b) Propriety- observance of the general principles governing sound financial management and the ethical conduct of public officials.

While regularity is emphasized in compliance auditing, propriety is equally pertinent in the public sector context, in which there are certain expectations concerning financial management and the conduct of officials.

Under Article 151, audit reports of the C&AG relating to the accounts of the Central/ State Government should be submitted to the President/Governor of the State who shall cause them to be laid before Parliament/State Legislative Assemblies.

In the given situation, the report relates to the State Department. Therefore, report was likely to have been submitted to Governor of state to be laid before State legislative assembly.

10. The likely objectives of performance audit to be conducted by office of C & AG of India of some selected social security pension schemes and scholarship schemes in a state could be: -

- *Whether proper planning and process were in place to capture data of beneficiaries under above schemes*
- *Whether necessary steps were taken for implementation of DBT like preventing delay in payments to the intended beneficiaries and pilferage and duplication*
- *Whether the infrastructure, organization and management of DBT were adequate and effective.*

"Audit criteria" are standards used to determine whether a programme meets or exceeds expectations. It provides a context for understanding the results of the audit. Audit criteria are reasonable and attainable standards of performance against which economy, efficiency and effectiveness of programmes and activities can be assessed.

In the above situation, various documents issued by Government of India and state government like circulars, instructions, Standard operating procedure manuals, guidelines of schemes on identification and authentication of beneficiaries etc, general management and subject matter literature can be used to determine "audit criteria".

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CHAPTER 16

INTERNAL AUDIT



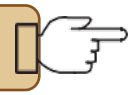
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Know the meaning and scope of Internal Audit.
- Gain the knowledge of the internal audit as per provisions of the Companies Act, 2013.
- Gain understanding of basic steps and activities involved in internal audit.
- Gain understanding of drafting of internal audit report.
- Analyse the relationship between Internal and External Auditors.
- Understand the Audit Trail.
- Acquire the knowledge of basics of the Standards on Internal Audit issued by the ICAI.

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CHAPTER OVERVIEW





Try and Scale Limited, a listed company, has advertised for the position of *"Chief Internal Auditor"* of the company in few prominent pink newspapers. CA P is offered the position after duly vetting his credentials. The offer letter of the company states that Chief Internal Auditor is required to report to the CFO of the company. On going through contents of letter, he finds it weird. What is unusual about it and why?

Since internal audit is an independent function, the Internal Auditor has to be free from any undue influences which force him to deviate from the truth. Also, the internal auditor has to resist any undue pressure or interference in establishing the scope of the assignments or the manner in which these are conducted and reported findings, particularly if they deviate from set objectives. The independence of internal auditor within the company plays a large part in establishing his independence.

CA P immediately flagged this issue to the company, pointing out that reporting to the CFO could compromise his independence as the Internal Auditor. He advised that to ensure independence of internal audit function, he should be positioned outside the functions which are subject to internal audit (e.g., Finance and Accounts) and he should report directly to the Audit Committee.

Besides, the offer letter also hinted at his role in "system automation" and "process re-engineering" in the company. Assuming proposed roles in above areas can also mar his independence. He was confused. "System automation" and "process re-engineering" are in nature of operational responsibilities. How he can accept responsibilities in this regard? Considering above, he thought it worthwhile to give a caveat to the company that he would not be in a position to assume accountability of these areas. He informed the company that

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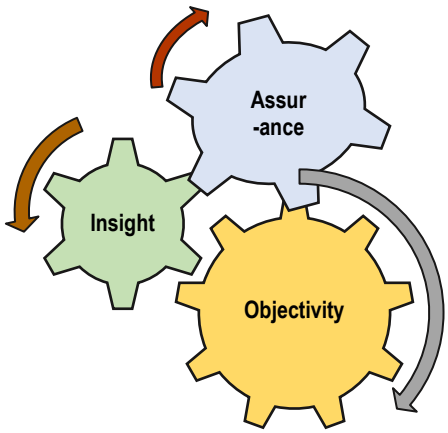
he would not be able to take operational decisions in these areas that could later fall within the scope of an internal audit. He would be able to accept only limited operational role and that too for a short duration.

The company agreed to both the issues flagged by him and accepted the position.

After accepting appointment, he adopted a risk-based approach for identifying important audit areas. The company's operations were numerous and diversified. It made sense to him to adopt a system and process focused approach in conducting audit procedures. Such an approach would go a long way in "error prevention." His focus remained on preventing errors at the first place. Such an approach strengthens company's internal systems leading to improvement in governance mechanisms.

1. INTERNAL AUDIT

The operation of many modern organisations have become complex with high volume of transactions carried out at multiple locations with increasing dependency on technology. This has caused further more delegation of authorities and decentralisation of activities. Consequently, key stakeholders including Board of Directors, top management, shareholders, lenders, investors and government are concerned with the propriety of the day-to-day affairs of the organization and reliability of the various financial and non-financial information being recorded and reported to the stakeholders. Accordingly, the stakeholders get internal audit conducted to obtain report on the deficiency in internal control system and underlying transactions for better governance of organization and take timely remedial actions wherever needed.



The Institute of Chartered Accountants of India constituted the Internal Audit Standards Board (IASB) as a non-standing technical board on February 5, 2004. The Internal Audit Standard Board (earlier known as the Committee on Internal Audit) is constituted with the object of formulating Standards on Internal Audit (SIAs), Guidance Notes on Internal Audit, continuously review the Standards and Guidance Notes, and to formulate and review Implementation Guides, Technical Guides, Practice Manuals, Studies and other papers, which may be issued under its own authority

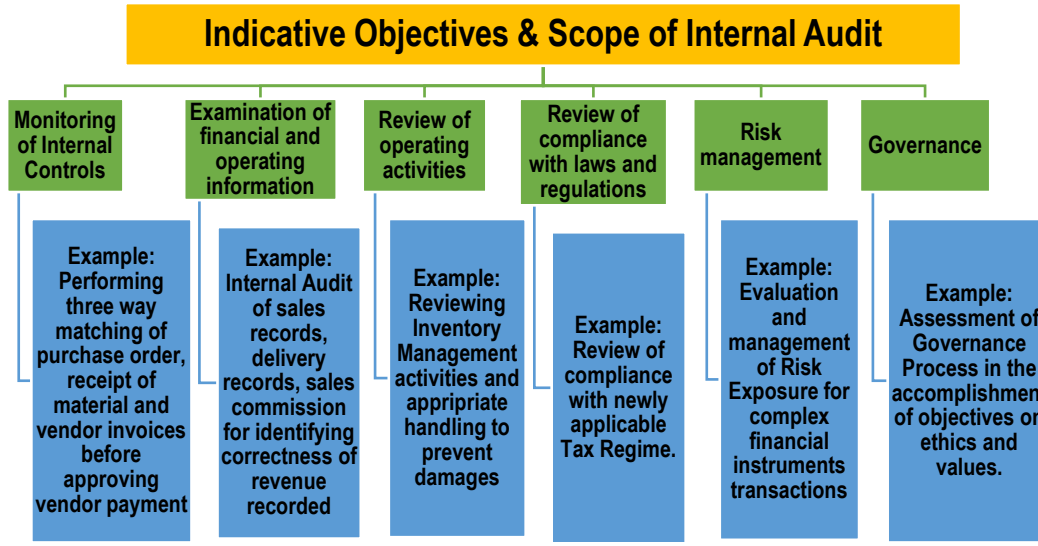
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for guidance of the members, as felt appropriate by the Board. Besides, the IASB also undertakes research and promote knowledge dissemination in the field of internal audit.

Definition of Internal Audit: As defined in Framework Governing Internal Audits, "Internal Audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives."

The Framework also indicates the nature of internal audit services may go beyond assurance to include an advisory (consulting) role to help an organization achieve its objectives, provided this does not compromise the independence of the internal auditor. The internal auditing is not confined to financial transactions only and include review of operational activities, underlying internal controls, compliance to applicable laws and regulations. The objectives and scope of Internal Audit Function as per SA 610, "Using the Work of an Internal Auditor" may include:

• Monitoring of internal controls;	• Review of compliance with laws and regulations
• Examination of financial and operating information	• Risk management
• Review of operating activities	• Governance



Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, following class of companies (prescribed in rule 13 of Companies (Accounts) Rules,2014) shall be required to appoint an internal auditor which may be either an individual or a partnership firm or a body corporate, namely-

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(a)	**every listed company;**
(b)	**every unlisted public company having-**
	(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
	(ii) turnover of two hundred crore rupees or more during the preceding financial year; or
	(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
	(iv) outstanding deposits of twenty-five crore rupees or more at any point of time during the preceding financial year; and
(c)	**every private company having-**
	(i) turnover of two hundred crore rupees or more during the preceding financial year; or
	(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

It is provided that when an existing company gets covered under any of the above criteria it shall comply with the requirements within six months of commencement of such applicability.

CASE STUDY 1

JKT Pvt. Ltd. is having ₹ 40 lacs paid-up capital, ₹9.50 crores reserves and turnover of the last three consecutive financial years, immediately preceding the financial year under audit, being ₹ 49 crores, ₹ 145 crores and ₹ 260 crores, but does not have any internal audit system. In view of the management, the internal audit system is not mandatory. Comment.

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, read with rule 13 of the Companies (Audit and Auditors) Rules, 2014, every private company shall be required to appoint an internal auditor or a firm of internal auditors, having

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

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Conclusion: In the instant case, JKT Pvt. Ltd. is having a turnover of ₹ 260 crores during the preceding financial year which is more than two hundred crore rupees. Hence, the company has the statutory requirement to appoint an Internal Auditor and mandatorily conduct an internal audit.

Who can be Appointed as an Internal Auditor?

- As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.
- The internal auditor may or may not be an employee of the company.
- To be effective, the internal auditor must be regarded as a part of the management and not merely as an assistant thereto. Furthermore, he or she must have the authority to investigate every organisational activity to meet the objectives and scope of the internal audit.



1. AB Pvt. Ltd. company, having outstanding loans and borrowings from banks exceeding one hundred crore rupees, wants to appoint Mr. X, a practicing cost accountant, as an internal auditor. Is the appointment of Mr. X valid?

Provision & Conclusion: According to the provision given in section 138 of the Companies Act, 2013, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the companies. Thus, Appointment of **Conclusion**: Thus, appointment of Mr. X as an internal auditor of AB Pvt. Ltd. is valid.

As per Standard on Internal Audit (SIA) 210 Managing the Internal Audit Function, the Internal Audit Function performs a number of activities to achieve its objectives as outlined in its Charter (or Terms of Engagement). A few of the critical activities are as follows:

(a)	**Define the overall plan, scope and methodology of the Internal Audit Function on a periodic basis.**
(b)	**Oversee and monitor various audit assignments, their proper planning, execution, reporting of findings and subsequent closure of reported observations.**
(c)	**Plan, acquire, engage and review the performance, training and development of professional staff, talent and other resources to achieve its objectives.**
(d)	**Identify, source, engage and manage external experts and technical solutions, if required.**

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(e)	Communicate and engage with all key stakeholders regarding progress and achievement of objectives.
(f)	Develop and maintain a quality evaluation and improvement program.

With respect to the accounting function and financial records of the organisation, the responsibilities of an Internal Auditor include:

- to ascertain adequacy of system of internal control by a continuous examination of accounting procedures, receipts and disbursements, and to provide adequate safeguards against misappropriation of assets.
- to operate independently of the accounting staff and must not in any way divest with any of the responsibilities placed upon him.
- Not to involve in the performance of executive functions in order that the objective outlook does not get obscured by the creation of the vested interest.
- to observe facts and situations and bring them to notice of authorities who would otherwise never know them; also, critically appraise various policies of the management and draw its attention to any deficiencies, wherever these require to be corrected.
- to associate closely with management and keep knowledge up to date by being informed about all important occurrences and events affecting the business, as well as the changes that are made in business policies.
- At all times, the internal auditor must enjoy an independent status.

At times, the Internal Auditor is exposed to a different type of risk to independence, whereby management seeks active business support from the Internal Auditor.

Apart from providing assurance on internal controls over the operational activities of the organization, the Internal Auditor may be sometimes assigned responsibility to provide advisory inputs on governance activities such as risk management, framework of monitoring statutory compliances, automation of activities, avenues of process re-engineering with increase operational efficiency, code of ethics etc.

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2. MANAGEMENT FUNCTIONS AND SCOPE OF INTERNAL AUDITING

Management is a process by which the affairs of an enterprise are conducted in such a manner that its goals and objectives are attained through optimum utilisation of all available resources, within the legal, social, economic and environmental constraints. To achieve optimum utilisation of resources management should determine the goals and objectives of the concern, quantify them to the extent possible, develop major policies and plans, implement them and exercise control over such implementation.

In the case of Companies required to appoint an Internal Auditor as per Section 138 of the Companies Act, 2013, Rule 13(2) of Companies (Accounts) Rules 2014, states: "The Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity, and methodology for conducting the internal audit." Hence, in this class of companies, the Audit Committee or the Board, in conjunction with management and the Chief of Internal Audit, is expected to exercise the responsibility to formulate the objectives of internal audit. In the case of other organisations not covered under Rule 13, those who appoint the Internal Auditor (e.g., the owners, the promoters, the Board of Trustees, etc.) would generally define the objectives of internal audit.

The internal auditor should, in consultation with those charged with governance, including the audit committee, develop and document a plan for each internal audit engagement to help him conduct the engagement in an efficient and timely manner.

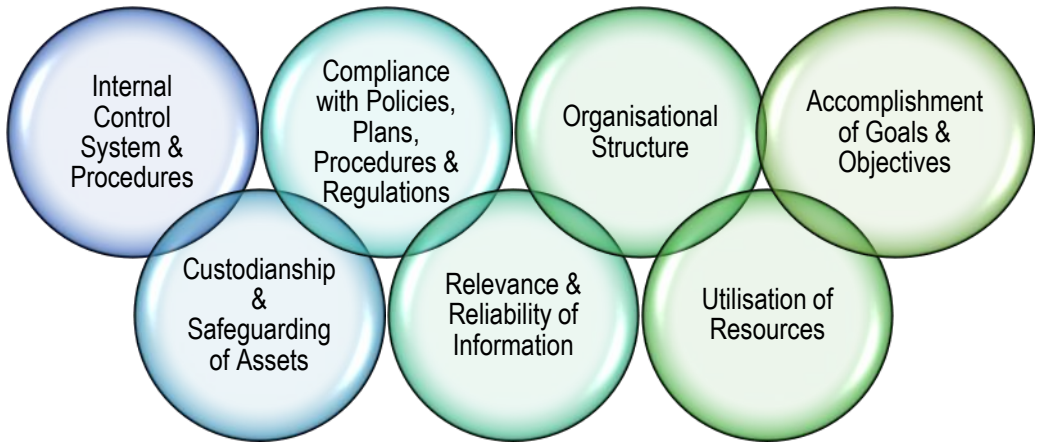
Internal audit plan should be developed in such a manner that all the business processes covering both financial as well as operational activities are reviewed by internal audit function within a defined time cycle. Also, ensuring that appropriate consideration is made, and adequate balance is ensured to the following:

- Risk underlying the business process
- Value that the internal audit can provide to the organization
- Effort involved in conducting the internal audit for a particular business process
- Risk Appetite of the organization
- Coverage of all auditable areas within the defined time range

In addition, each of the managerial functions should be reviewed by the internal auditor.

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The scope of internal auditor's work should also include a review of-



On the basis of such review, the internal auditor should in his report, highlight the weaknesses observed and give suggestions for improvement. We may now have a brief description of each of the above areas of review:

(i) Review of Internal Control System and Procedures -

(a) The review of internal control system and procedures involves assessing the design and operational efficiency and effectiveness of the internal control system to strengthen the overall internal control environment of the entity. The objective to review is to minimise the overall residual risk by suggesting the appropriate controls to reduce the inherent risk.



2. Review of three-way matching internal control involves matching of Purchase Orders, Goods Receipt Notes and Invoice to ensure all the ordered quantity of the intended goods have been received and invoiced accordingly. The failure of this internal control may involve over-invoicing, over-payment, non-receipt, or under-receipt of goods.

As far as possible, controls should be in-built in the operating functions for prevention or timely detection of the fraud and errors and minimize the cost of control.

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3. The establishment of a separate credit control department would not be justified if the objective of reducing credit risk and minimising debt recovery period could be met through controls in-built in the accounting and sales systems, especially in smaller and medium-sized concerns.

(b) Internal Control System should be reviewed considering the limitations of internal controls, i.e., cost-benefit comparison, human errors, collusion, and abuse by process owners.



4. Collusion of payment authorizer and payment maker to overpay a related party; those charged with governance themselves overriding the internal controls with malafide intention, etc.

It should also be seen whether the internal controls were in use throughout the period of intended reliance. A break-down in internal controls for a specific portion of intended reliance would need special attention.

(ii) Review of Custodianship and Safeguarding of Assets -

- This involves verifying the existence of the assets.
- The internal auditor should review the segregation of duties is in place.
- The internal auditor should review the control systems to ensure that all assets are accounted for fully. He should review the means used for safeguarding assets against losses **e.g. fire, improper or negligent activity, theft and illegal acts, etc**.
- He should review the control systems for intangible assets e.g. the procedures relating to credit control. Where an enterprise uses electronic data processing equipment, the physical and systems control on processing facilities as well as on data storage should be examined and tested.



5. The existence of intangible assets could be only an annual subscription in the name of an entity, for example, an annual ERP subscription.

(iii) Review of Compliance with Policies, Plans, Procedures and Regulations - It is essential that the various functional segments of an enterprise comply with the relevant policies, plans, procedures, laws and regulations so that the operations are carried out in a coordinated manner. He should examine the system of periodical review of existing policies particularly when there is a change in the method and nature of operations of the enterprise. By

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combining the results of his review of the adequacy of the systems with the result of his compliance tests, the internal auditor should be able to evaluate the effectiveness of the former. He should point out specific weaknesses and suggest remedial action.

(iv) **Review of Relevance and Reliability of Information -** The internal auditor should review the information systems to evaluate the reliability and integrity of financial and operating information given to management and to external agencies such as governmental bodies, investors, trade organisations, labour unions, etc. He should examine the accuracy and reliability of financial and operational records. The usefulness of the reports as well as of the records should be evaluated with reference to their costs. The internal auditor should examine whether the reporting is by exception i.e. the reports highlight the significant and distinctive features. In case of automated management information system, where relevant information used for critical decision making is generated from the computer system, then adequacy of the controls build in the system should be reviewed to ensure data integrity and reliability of such information.

(v) **Review of the Organisation Structure -** The internal auditor should conduct an appraisal of the organisation structure to ascertain whether it is in harmony with the objectives of the enterprise and whether the assignment of responsibilities is in consonance therewith. For this purpose:

- He should review the manner in which the activities of the enterprise are grouped for managerial control. It is also important to review whether responsibility and authority are in harmony with the grouping pattern.
- The internal auditor should examine the organisation chart to find out whether the structure is simple and economical and that no function enjoys an undue dominance over the others.
- He should particularly see that the responsibilities of managerial staff at headquarters do not overlap with those of chief executives at operating units. He should examine whether there is a satisfactory balance between the authority and responsibility of important executives.
- The internal auditor should examine the reasonableness of the span of control of each executive (the number of subordinates that an executive controls). He should examine whether there is a unity of command i.e., whether each person reports only to one superior.

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- Where dual responsibilities cannot be avoided, the primary one should be specified and the specific responsibility to each senior fixed. This must be made known to all concerned.
- He should review adequate segregation of duties is considered while defining the organization structure.
- Finally, he should evaluate the process of managerial development in the enterprise.

(vi) Review of Utilisation of Resources –

- The internal auditor should check whether proper operating standards and norms have been established for measuring the economical and efficient use of resources.
- They should be detailed enough to be identifiable with specific operating responsibilities and should be capable of being used by operating personnel for monitoring and evaluating their performance.
- The internal auditor should review the methods of establishing operating standards and norms. He should carefully examine the assumptions made while setting the standards to ensure that they are appropriate and necessary.
- Where there is a wide divergence between actual performance and the corresponding standards, reasons may be considered. As a part of evaluating resources utilisation, identifying the facilities which are under-utilized is an important function of the internal auditor.



6. For example, it may consist of under-utilized machines, unoccupied storage space, huge cash or bank balances, idle manpower, etc. While commenting on staffing, the internal auditor should pay special attention to non-productive work being performed. This would require an inquiry into the job descriptions of employees combined with an intelligent observation of the work being done.

(vii) Review of Accomplishment of Goals and Objectives - The internal auditor should review the overall objectives of the enterprise to evaluate whether they are clearly stated and are attainable. The internal auditor should examine whether, to the extent possible, objectives are expressed in precise quantifiable terms (both monetary and non-monetary) to facilitate detailed planning to be made for achieving them. Budgeting forms an important part of such planning. This will ensure that plans anticipate the problem areas. There should also be sufficient flexibility in the plans to permit such improvements in their implementation, as would benefit the enterprises as a whole.

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3. INTEGRITY, OBJECTIVITY AND INDEPENDENCE OF INTERNAL AUDITOR

There is a set of core principles fundamental to the internal audit function and activities. These basic principles of internal audit are critical to achieving the desired objectives as set out in the Definition of Internal Audit. The basic principles of Internal Audit are a set of core principles fundamental to the function and activity of internal audit.

1. The Internal Auditor shall be free from any undue influences which force him to deviate from the truth. This independence shall be not only in mind but also in appearance. Also, the internal auditor shall resist any undue pressure or interference in establishing the scope of the assignments or the manner in which these are conducted and reported, in case these deviate from set objectives.

   The independence of the internal audit function as a whole, and the Internal Auditor within the organisation, plays a large part in establishing the independence of the Internal Auditor. The overall organisation structure of key personnel, the position and reporting of the Chief Internal Auditor within this structure, along with the powers and authority which is derived from superiors further establishes the independence of the Internal Auditor.

2. The Internal Auditor shall be honest, truthful and be a person of high integrity. He shall operate in a highly professional manner and seen to be fair in all his dealings. He shall avoid all conflicts of interest and not seek to derive any undue personal benefit or advantage from his position.

3. The Internal Auditor shall conduct his work in a highly objective manner, especially in gathering and evaluation of facts and evidence. He shall not allow prejudice or bias to override his objectivity, especially in arriving at conclusions or reporting his opinion.



7. For example, to avoid any conflict of interest, the internal auditor should not review an activity for which he was previously responsible. It is also expected from the management to take steps necessary for providing an environment conducive to enable the internal auditor to discharge his responsibilities independently and also report his findings without any management interference.



8. For example, in the case of a listed company, the internal auditor may be required to report directly to those charged with governance, such as the Audit Committee instead of the Chief Executive Officer or the Chief Financial Officer. The internal auditor

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should immediately bring any actual or apparent conflict of interest to the attention of the appropriate level of management so that necessary corrective action may be taken.

TEST YOUR UNDERSTANDING 1

After an illustrious career in Indian Audit & Accounts Service for about 25 years, Parteek, a postgraduate in law, has taken voluntary retirement from government service. Being in fine spirits, he wants to take responsibility as Chief internal auditor in the corporate sector. On looking at attractive compensation packages, he applied for such position in a leading listed company engaged in oil refining business. The Board of company is keen on him due to his impressive credentials.

Can he be appointed in this leading position of said company?

TEST YOUR UNDERSTANDING 2

CA Deva is an internal auditor of a listed company. The company wants to make sure that it is in compliance with SEBI requirements at all times and it is never on the wrong side of the law. It asks its internal auditor to manage its compliance tracking system including directly corresponding with regulator in this regard. The profile and scope of internal audit agreed at time of appointment included *"compliance with laws and regulations."*

Can he perform such type of activities in capacity of internal auditor of company?

4. QUALITIES OF INTERNAL AUDITOR

Internal auditor is required to objectively review overall governance and operational functions of the organization and, is required to internal with various stakeholders and other employees of the organisation. To perform his duties effectively, he is required to possess good knowledge of the subject matter, underlying information system and good soft skills.

Some of the specialised knowledge and expertise that Internal Auditor should obtain are:

1.	The internal auditor should have the special expertise necessary for evaluating management control systems, especially financial and accounting controls.
2.	Accounting and finance functions provide basic data for management control of an enterprise. Therefore, the internal auditor must have accounting and financial expertise to be able to discharge his duties.

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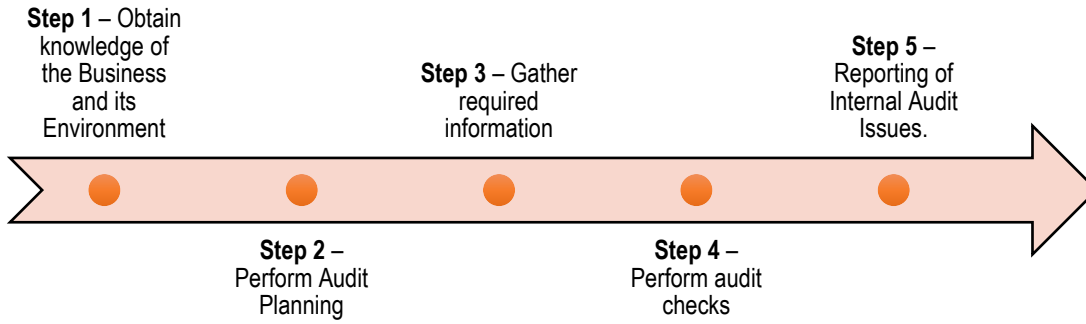
3.	The internal auditor is also expected to evaluate both financial and operational controls. This requires a good knowledge of the operations of the organization, technology and commercial practices of the enterprise.
4.	He should also have a good knowledge of commerce, laws, taxation, cost accounting, economics, quantitative methods and EDP systems.
5.	An understanding of the accounting software, ERP system and other applications being used by the organization along with the knowledge of the basic controls related to Information Technology.
6.	An understanding of management principles and techniques is another essential qualification of an internal auditor as also the ability to deal with people.
7.	By his conduct the internal auditor should provide an assurance to the management that the confidentiality of such information would be maintained



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5. PERFORMING INTERNAL AUDIT ENGAGEMENT

Typical internal audit engagement comprises of following five steps:



All of these steps are required to be performed while performing any Internal Audit engagement in the same sequence. Let us see some of the major activities to be performed under each of these steps:

Step 1 – Obtain Knowledge of the Business and its Environment

Internal Auditor must conduct meetings with key stakeholders, Board of Directors and Key management personals to obtain understanding of the organization's business environment, its operations, organization's vision, mission and top management's expectations from the audit functions.

Internal auditor must obtain understanding of various business documents – Standard Operating Procedures and Financial Statement Etc.

Internal auditor must also obtain understanding of the underlying Information Technology landscape, various applications and ERP systems of the organization and Management Information System of the organization.

Internal auditor must also obtain understanding of the regulatory landscape and various laws and regulations that are applicable to the organization.

Step 2 – Perform Audit Planning

Internal Auditor must plan the audit engagement as per the Standard on Internal Audit (SIA) 310, Planning the Internal Audit Assignment. Audit scope must be approved by Audit Committee and Board of Directors.

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Once approved, Internal Auditor must share detailed Audit Plan with the key managerial personals and plan in advance the detailed schedule of the Internal Audit to be conducted.

Internal Auditor must conduct the opening meeting with key stakeholders before start of audit engagement and share details of Information and System Access required to perform the audit.

Detailed work plan must be prepared by the audit managers and approved with Head of Internal Audit / Chief Internal Auditor. The work plan must be prepared after performing the evaluation of all major underlying risks in the process being reviewed and the audit checks to be performed to assess the adequacy of the control environment to mitigate such risks.

Step 3 – Gather Required Information

Internal Auditor must obtain the required information and perform checks to ensure correctness and integrity of information received. To the extent possible, Internal Auditor must obtain the information directly from the source.

Adequate planning should be done and advance intimation should be made for any interim information needed for performing audit checks.

Step 4 – Perform Audit Checks

Internal Auditor should collate all data and perform analytical procedures to identify key trends and outliers. Analytical procedures should be performed in accordance with the Standard on Internal Audit (SIA) 6, Analytical Procedures. To the extent possible, relevant analytical tools may be used to perform review of the complete data for the audit period.

Wherever needed, Internal Auditor must select the sample in accordance with Standard on Internal Audit (SIA) 5, Sampling.

Detailed audit testing must be performed as per the audit work plan. Internal Auditor must ensure adequate evidence must be collected and stores in accordance to Standard on Internal Audit (SIA) 320, Internal Audit Evidence

Internal Auditor must prepare detailed list of the Identified audit issues and controls gaps. Interim reports may be issued after proper review of the work performed as per the Standard on Internal Audit (SIA) 350, Review and Supervision of Audit Assignments.

Adequate document of the internal audit work papers needs to be ensured as per Standard on Internal Audit (SIA) 330, Internal Audit Documentation.

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Step 5 – Reporting of Internal Audit Issues

Internal Auditor must prepare a draft report of Internal Audit issues comprising of the business process/ function reviewed as per scope, detailed audit coverage and exclusions, if any, audit period covered during the audit, summary along with detailed issues over the gaps noted along with implication of the business and recommendation to mitigate the identified gaps.

Management Action Plan should be agreed along with responsibility of action and timelines for actions. Internal Auditor must also review the status of actions taken by the management against the actions agreed during previous audits and report the status of such follow up in the audit report.

Internal Auditor should thereafter circulate Final Report and presentation his findings to the Audit Committee. Internal auditor must adhere to Standard on Internal Audit (SIA) 360, Communication with Management and Standard on Internal Audit (SIA) 370, Reporting Results while sharing the result of internal audit with the stakeholders.

6. INTERNAL AUDIT REPORT

The internal auditor should carefully review and assess the conclusions drawn from the audit evidence obtained, as the basis for his findings contained in his report and suggest remedial action. However, in case the internal auditor comes across any actual or suspected fraud or any other misappropriation of assets, it would be more appropriate for him to bring the same immediately to the attention of the management.

As per Standard on Internal Audit (SIA) 370 Reporting Results, reporting of internal audit results is generally undertaken in two stages:

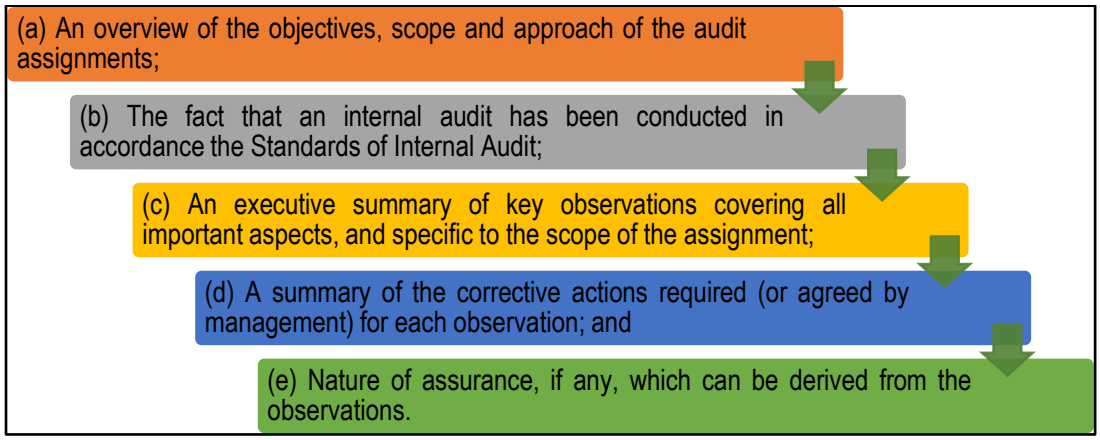
At the end of a particular audit assignment, an "Internal Audit Report" covering a specific area, function or part of the entity is prepared by the Internal Auditor highlighting key observations arising from those assignments. This report is generally issued with details of the manner in which the assignment was conducted and the key findings from the audit procedures undertaken. This report is issued to the auditee, with copies shared with local and executive management, as agreed during the planning phase.

On a periodic basis, at the close of a plan period, a comprehensive report of all the internal audit activities covering the entity and the plan period is prepared by the Chief Internal Auditor (or the Engagement Partner, in case of external service provider). Such reporting is normally done on a quarterly basis and submitted to the highest governing authority responsible for internal audits, generally the Audit Committee. Some part of the aforementioned Internal Audit Reports may form part of the periodic (e.g. Quarterly) report shared with the Audit Committee.

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This Standard on Internal Audit (SIA) deals with the internal auditor's responsibility to issue only the first type of reports, the Internal Audit Report pertaining to specific audit assignments and not to the periodic (e.g. Quarterly) reporting for the whole entity as per the Annual/Quarterly audit plan.

On the basis of the internal audit work completed, the Internal Auditor shall issue a clear, well documented Internal Audit Report which includes the following key elements:



The content and form of the Internal Audit Report are to be established by the Internal Auditor based on his best professional judgement, in consultation with the auditee and, if necessary, with inputs from other key stakeholders. No internal audit report shall be issued in final form unless a written draft of the report has previously been shared with the auditee.

The internal audit report shall be issued within a reasonable time frame from the completion of the internal audit work.

1. Basis of Internal Audit Report: Each internal audit report is prepared on the basis of the audit procedures conducted and the analysis of the audit evidence gathered. Conclusions reached shall be based on all the findings rather than on a few deviations or issues noted. Controls operating effectively have their own importance and should be acknowledged, while the risk and significance of observations noted have a role to play in prioritising the matters to be reported.
2. Conducted in Accordance with SIAs: Where the internal audit is conducted in compliance with the Standards of Internal Audit, (within the Framework governing Internal Audits), and the internal auditor can substantiate the same with supporting evidence and documentation, the internal audit report shall include a statement confirming that "the internal audit was conducted in accordance with the Standards of Internal Audit issued by the Institute of Chartered Accountants of India".

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3. Content and Format of Internal Audit Report: The manner in which the internal audit report is drafted and presented is a matter of professional judgment and choice and could be influenced by the preferences of the recipients. The SIA does not mandate any particular format or list of contents since the Internal Auditor is expected to exercise his best professional judgement on matters regarding how and what to report. Where some level of assurance is being provided, the form and content of the report shall be as per SIA 380, "Issuing Assurance Reports". A typical internal audit report should include the following:

- Audit Scope performed
- Audit period Covered
- Executive Summary
- Summary of the critical findings
- Detailed audit findings with elaboration on business impact and root cause of such issues
- Rating of the highlighted issues (E.g High / Medium / Low) in accordance to the rating criteria approved by Audit Committee
- Audit recommendation to improve control environment and address the highlighted finding
- Response received from the responsible functional authority containing action plan and target timelines for action

4. Documentation: To confirm compliance of audit procedures with this SIA, the list of documents required is as follows:

(a) Copies of draft and final internal audit reports to be maintained, appropriately cross referenced to specific observations.

(b) If appropriate, management action plans may be counter signed by respective management personnel.

6.1 Follow-up

As per SIA 390 Monitoring and Reporting of Prior Audit Issues, the Chief Internal Auditor is responsible for continuously monitoring the closure of prior audit issues through timely implementation of action plans included in past audits. This shall be done with a formal monitoring process, elements of which are pre-agreed with management and those charged with governance. The responsibility to implement the action plans remains with the management.

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In monitoring and reporting of prior audit issues, the responsibility of the Internal Auditor is usually in the form of an "Action Taken Report (ATR) of previous audits".

The term "Monitoring and Reporting" used in this Standard refers to the periodic tracking of issues raised during prior audits and evaluation of the corrective actions undertaken by the auditee to resolve them and to report any open and pending matters to the management and those charged with governance (e.g. the Audit Committee).

The internal auditor should review whether follow-up action is taken by the management on the basis of his report. If no action is taken within a reasonable time he should draw the management's attention to it. Where the management has not acted upon his suggestions or not implemented his recommendations, the internal auditor should ascertain the reasons thereof.

Where the management has accepted his recommendations and initiated the necessary action, the internal auditor should periodically review the manner and the extent of implementation of the recommendations and report to the management highlighting the recommendations which have not been implemented fully or partly.

7. RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL AUDITORS

- The scope and objective of internal audit are dependent upon the size and structure of the entity and the requirements of its management. As stated earlier the internal auditor operates in various areas such as review of the accounting system and internal control; examination of financial and operating information for the benefit of management, the examination of the economy, efficiency and effectiveness of operations including non-financial controls of various tangible assets of the entity. While operating in these areas, there is a lot of overlap between the work of internal auditors and external auditors.
- The work done by the internal auditor has an important bearing on the work performed by the statutory auditor as evaluation done by the internal auditor in respect of internal controls, reliability of financial information, verification of assets, etc. is also required to be done by the external auditor. The function of an internal auditor is an integral part of the system of internal control.

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- It is a statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.
- However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. For the purpose, he should examine the Internal Audit Department of the organisation, the strength of the internal audit staff, their qualification and their powers.
- The extent of independence exhibited by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit. But so far, the practice of audit being conducted jointly by the internal auditors is of great assistance to statutory auditors.
- The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluation, the external auditor may be able to adopt less extensive procedures than would otherwise be required.

Difference Between Internal & External Auditors

BASIS FOR COMPARISON	INTERNAL AUDIT	EXTERNAL AUDIT
1. Performed by	Internal audit is performed by an independent internal auditing function within the organisation or by external body.	It is an audit function performed by the independent body which is not a part of the organization.
2. Examination	The Internal auditor examines the adequacy of operational controls of the organisation.	The External auditor examines the Accuracy and Validity of Financial Statements.
3. Appointment	The Internal auditor is appointed by the Audit Committee or Board of Directors.	The External auditor is appointed by the Members.
4. Users of Report	Generally, internal audit report is used by top Management and referred by statutory auditor.	The user of external audit report is Stakeholders.
6. Reporting	Internal Audit Report provides weakness in internal controls and	The opinion is provided on the truthfulness and fairness of the

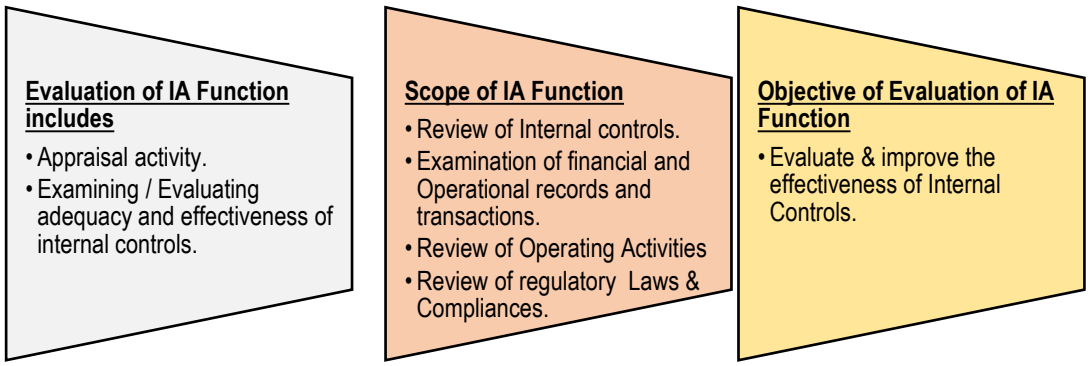
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	effectiveness of the operational activities.	financial statement of the company.
7. Status of Auditor	The Internal auditor could be an employee of the company.	The External auditor is mandatorily not an employee of the company.

SA 610, "Using the work of an Internal Auditor" deals with certain aspects of relationship between internal and external auditors.

7.1 Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

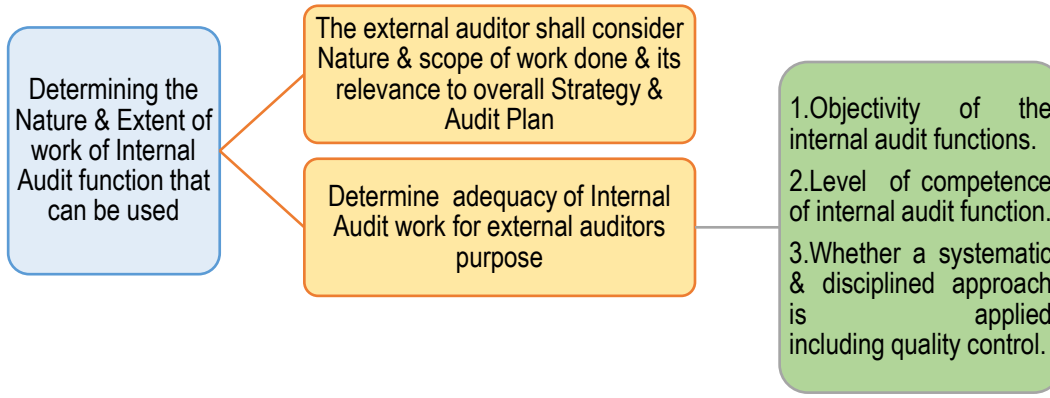
Evaluating the Internal Audit Function:



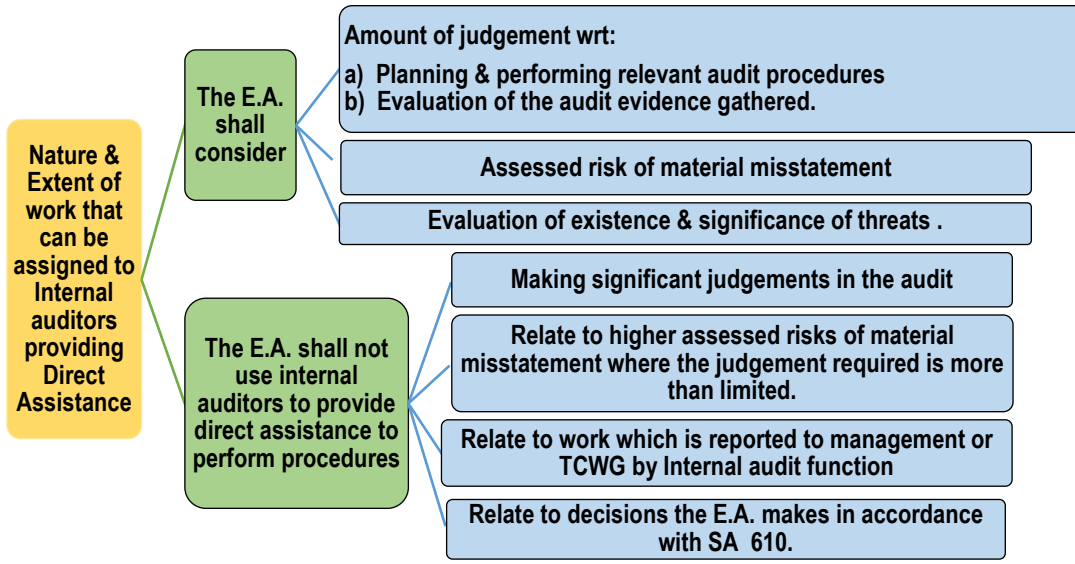
7.2 Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

The external auditor shall not use the work of the internal audit function if the external auditor determines that the function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors; the function lacks sufficient competence or the function does not apply a systematic and disciplined approach, including quality control.

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7.3 Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance



(A brief overview of using Direct Assistance from Internal Auditors by External Auditors)

The external auditor shall evaluate whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

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7.4 If the External Auditor uses Internal Auditors to Provide Direct Assistance on the Audit, the External Auditor shall include in the Audit Documentation

(a) The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;

(b) The basis for the decision regarding the nature and extent of the work performed by the internal auditors;

(c) Who reviewed the work performed and the date and extent of that review in accordance with SA 230 Audit Documentation;

(d) The written agreements obtained from an authorized representative of the entity and the internal auditors; and

(e) The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

Finally, in India, even the statute has now recognised that internal audit is necessary for the efficient running of companies. Thus, a review of the internal audit function in specified companies has become a statutory responsibility for the statutory auditor.

[**Note: Student are advised to refer SA 610 Using the work of Internal Auditor for more details**.]

Illustration 2

The Managing Director of X Ltd. is concerned about high employee attrition rate in his company. As the internal auditor of the company, he requests you to analyze the causes for the same. What factors would you consider in such analysis?

Solution

The factors responsible for high employee attrition rate are as under:

(i) Job Stress & work life imbalance;

(ii) Wrong policies of the Management;

(iii) Unbearable behaviour of Senior Staff;

(iv) Safety factors;

(v) Limited opportunities for promotion;

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(vi) Low monetary benefits;

(vii) Lack of labour welfare schemes;

(viii) Whether the organization has properly qualified and experienced personnel for the various levels of works?

(ix) Is the number of people employed at various work centres excessive or inadequate?

(x) Does the organization provide facilities for staff training so that employees and workers keep themselves abreast of current techniques and practices?

8. INTERNAL AUDIT AS A MANAGEMENT FUNCTION

Management is a process by which the affairs of an enterprise are conducted in such a manner that its goals and objectives are attained through optimum utilisation of all available resources, within the legal, social, economic and environmental constraints. At the most fundamental level, management functioning is a set of five general functions: planning, organizing, staffing, directing and controlling. While the first five functions of planning, organizing, staffing and leading are critical attributes to create and grow stakeholder's wealth whist controlling is the critical function that is key to preserve stakeholder's wealth.

As per the revised definition of the term 'Internal Audit' as per para 3 of the ICAI's Framework Governing Internal Audits, "Internal audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives". Accordingly Internal Auditor is expected to critically evaluate the management activities and advise them on the areas of improving internal controls and manage business and operational risks effectively by recommending appropriate mitigating controls.

Internal Audit is an important element of management controlling function, it helps management to set up appropriate systems and processes in place to mitigate risk while remaining independent to the operations. Internal Auditor is expected to report on the identified gaps and areas of weak internal control, further he is expected to identify the root cause of the problems and suggest appropriate mitigating steps and strengthen the internal controls environment of the organization.

Accordingly, Internal Audit is seen as an important function that helps management to achieve organization goals and perform its function in an orderly manner.

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9. AUDIT TRAIL

Audit Trail (or Edit Log) is a visible trail of evidence enabling one to trace information contained in statements or reports back to the original input source. Audit trails are a chronological record of the changes that have been made to the data. Any change to data including creating new data, updating or deleting data that must be recorded.

Records maintained as audit trail may include the following information:

- when changes were made i.e., date and time (timestamp)
- who made the change i.e., User Id
- what data was changed i.e., data/transaction reference; success/failure

Audit trails may be enabled at the accounting software level depending on the features available in such software or same may be captured directly in the database underlying such accounting software.

In order to demonstrate that the audit trail feature was functional, operated and was not disabled, a company would have to design and implement specific internal controls (predominantly IT controls) which in turn, would be evaluated by the auditors, as appropriate. An illustrative list of internal controls which may be required to be implemented and operated are given below:

- Controls to ensure that the audit trail feature has not been disabled or deactivated.
- Controls to ensure that User IDs are assigned to each individual and that User IDs are not shared.
- Controls to ensure that changes to the configurations of the audit trail are authorized and logs of such changes are maintained.
- Controls to ensure that access to the audit trail (and backups) is disabled or restricted and access logs, whenever the audit trails have been accessed, are maintained.
- Controls to ensure that periodic backups of the audit trails are taken and archived as per the statutory period specified under the provisions of the Act.

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TEST YOUR UNDERSTANDING 3

Up Down Limited is concerned about the decline in demand for its products in the last two years. The statutory auditor is of the view that the situation has put into question going concern assumption of the company. Its internal auditor has helped management in devising a strategy to deal with such risks and come out of the situation. The plan includes venturing into different product lines using the same plant with minor modifications. Further, the internal auditor has also prepared estimates of revenue generation along with cash flows.

Can statutory auditor place total reliance on work performed by internal auditor in this regard?

Key Takeaways

- Internal Audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives.
- It is mandatory for all listed companies, unlisted public companies/private companies fulfilling certain criteria to appoint internal auditor in accordance with provisions of Section 138 of the Companies Act, 2013 and relevant rules.
- The internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company in terms of section 138 of the Companies Act, 2013. He may or may not be employee of the company.
- In such companies specified in section 138 of the Companies Act, 2013, the Audit Committee or the Board, in conjunction with management and the Chief of Internal Audit, is expected to exercise the responsibility to formulate the objectives of internal audit.
- Basic principles governing an internal audit include independence, integrity and objectivity.
- Each internal audit report is prepared on the basis of the audit procedures conducted and the analysis of the audit evidence gathered. Conclusions reached shall be based on all the findings rather than on a few deviations or issues noted.
- Reporting of internal audit results is generally undertaken in two stages- At the end of a particular audit assignment, an *"Internal Audit Report"* covering a specific area, function or part of the entity is prepared by the Internal Auditor highlighting key observations arising from those assignments. Further, on a periodic basis, at the close of a plan period, a comprehensive report of all the internal audit activities covering the entity and the plan period

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is prepared by the Chief Internal Auditor (or the Engagement partner, in case of external service provider). Such reporting is normally done on a quarterly basis and submitted to the highest governing authority responsible for internal audits, generally the Audit Committee.

- The internal auditor should review whether follow-up action is taken by the management on the basis of his report. If no action is taken within a reasonable time he should draw the management's attention to it. Where the management has not acted upon his suggestions or not implemented his recommendations, the internal auditor should ascertain the reasons thereof.
- The work done by the internal auditor has an important bearing on the work performed by the statutory auditor as evaluation done by the internal auditor in respect of internal controls, reliability of financial information, verification of assets, etc. is also required to be done by the external auditor.
- It is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. For the purpose, he should examine the Internal Audit Department of the organisation, the strength of the internal audit staff, their qualification and their powers.
- The extent of independence exhibited by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit.
- The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures.
- The external auditor shall not use the work of the internal audit function if the external auditor determines that the function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors; the function lacks sufficient competence or the function does not apply a systematic and disciplined approach, including quality control.
- Standards on Internal audit are recommendatory in nature.

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APPENDIX

The following Standards on Internal Audit are recommendatory in nature. The Standards shall become mandatory from such date as notified by the council:

Section I: Preface

Preface to the Framework and Standards on Internal Audit

Section II: Framework

Framework Governing Internal Audits

Section III: Basic Principles

Basic Principles of Internal Audit

Section IV: Standards on Key Concepts (100 Series)

SIA 110: Nature of Assurance

SIA 120: Internal Controls

SIA 130: Risk Management

SIA 140: Governance

SIA 150: Compliance with Laws and Regulations

Section V: Standards on Internal Audit Management (200 Series)

SIA 210: Managing the Internal Audit Function

SIA 220: Conducting Overall Internal Audit Planning

SIA 230: Objectives of Internal Audit

SIA 240: Using the Work of an Expert

SIA 250: Communication with Those Charged with Governance

Section VI: Standards on the Conduct of Audit Assignments (300 - 400 Series)

SIA 310: Planning the Internal Audit Assignment

SIA 320: Internal Audit Evidence

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SIA 330: Internal Audit Documentation

SIA 350: Review and Supervision of Audit Assignments

SIA 360: Communication with Management

SIA 370: Reporting Results

SIA 390: Monitoring and Reporting of Prior Audit Issues

Section VII: Standards on Specialised Areas (500 Series)

SIA 520: Internal Auditing in an Information Technology Environment

SIA 530: Third Party Service Provider

Section VIII: Standards on Internal Audit (As on July 1, 2013)

SIA 5: Sampling

SIA 6: Analytical Procedures

SIA 7: Quality Assurance in Internal Audit

SIA 11: Consideration of Fraud in an Internal Audit

SIA 18: Related Parties

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Write a short note on the Internal Audit Report.*
2. *State the important aspects to be considered by the External auditor in the evaluation of the Internal Audit Function.*
3. *AB Pvt. Ltd. company has outstanding loans or borrowings from banks exceeding one hundred crore rupees wants to appoint an internal auditor. Please guide him for the applicability of the same and who can be appointed as an internal auditor and what work would be reviewed by him.*

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4. *Moon Ltd., of which you are the Statutory Auditor, have an internal audit being conducted by an outside agency. State the factors that weigh considerations in opting to make use of direct assistance of the internal auditors for the purpose of statutory audit.*

5. *Mr. A is appointed as a statutory auditor of XYZ Ltd. XYZ Ltd. is required to appoint an internal auditor as per statutory provisions given in the Companies Act, 2013 and appointed Mr. B as its internal auditor. The external auditor Mr. A asked internal auditor to provide direct assistance to him regarding evaluating significant accounting estimates by the management and assessing the risk of material misstatements.*

   (a) Discuss whether Mr. A, statutory auditor, can ask direct assistance from Mr. B, internal auditor as stated above in view of auditing standards.

   (b) Will your answer be different if Mr. A asks direct assistance from Mr. B, internal auditor with respect to external confirmation requests and evaluation of the results of external confirmation procedures?

6. *The XYZ Ltd. has to appoint Mr. A as Chief Internal Auditor to lead the internal audit function for the Company. The Managing Director of the Company has asked the HR head to define the reporting structure of the Chief Internal Auditor, so that he can discharge his duties objectively? Suggest the ideal reporting structure of the Chief Internal Auditor that HR head may propose to the Managing Director?*

7. *Daksh Ltd. has appointed Mr. Gopal to conduct their internal audit for the new financial year. The Audit committee requested Mr. Gopal to present their Internal Audit plan for next financial year? What approach would Mr. Gopal follow to prepare the internal audit plan for next year?*

8. *Zero Ltd. has appointed Mr. Shubh to conduct their internal audit for the new financial year. The Audit committee requested Mr. Shubh to perform a detailed analysis of their expenses in the previous year and report on all risks and underlying gaps.* ***Elucidate the steps Internal Auditor should take to identify such gaps?***

9. *Kishore Ltd. has appointed Mr. Anand to conduct their internal audit for the new financial year. The Audit committee requested Mr. Anand to present a detailed report on their findings and areas where immediate action is needed to mitigate critical risks. What should be the content of the internal audit report to address this requirement of the Audit Committee?*

10. *June Ltd. has appointed Mr. Gaurav to conduct their internal audit for the new financial year. The Audit committee requested Mr. A to present their analysis on the implementation of recommendations of previous audit report and highlight critical areas which need immediate*

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attention of the Audit Committee? What should be the steps followed by internal auditor to address this requirement of the Audit Committee?

11. ***One of the independent directors sought information regarding the appointment of internal auditors for the following Group Companies in accordance with the Companies Act, 2013 of which certain financial information is given below:***

Figures are in ₹ crore and correspond to the previous year.

Name	*Nature*	*Equity Share Capital*	*Turnover*	*Loan from Bank and PFI*	*Public Deposits*
XYX Limited	*Listed*	*100*	*230*	*20*	*48*
MNM Limited	*Unlisted Public*	*60*	*100*	*50*	*24*
GFG Limited	*Unlisted Private*	*70*	*180*	*80*	*-*

You are required to evaluate the requirements regarding the appointment of internal Auditors for the Group Companies. Discuss.

12. ***Rishi is appointed as internal auditor for SPOM Limited, a medium-sized manufacturing company, while CA Nitin is the statutory auditor of SPOM Limited.***

    (a) ***During the review, Rishi notices several discrepancies in the disbursement records and suspects there might be weaknesses in the internal control system. Additionally, there have been recent changes in the company's business policies that he was not informed about. Rishi is concerned about maintaining his independence and objectivity while ensuring that management is aware of these issues. What are the responsibilities of Rishi as an Internal Auditor with respect to the accounting function and financial records of the organisation?***

    (b) ***CA Nitin asked Rishi to provide direct assistance to him regarding evaluating the appropriateness of management's use of the going concern assumption. In view of Standards on Auditing, whether Nitin can ask direct assistance from Rishi as stated above?***

13. ***CA Sanjana has recently joined as Chief Internal Auditor of Up Scale Limited, a listed company. Her subordinate staff in the internal audit department brings to her knowledge many prior audit issues highlighted in the previous internal audit reports***

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which are still open. Does she have any responsibilities in this regard? How should she proceed in this situation?

14. ***STU & Associates have been the statutory auditors of the listed company "First and Last Ltd.," operating in the petrochemical industry, for the past three years. CA K, the engagement partner, had designed certain substantive procedures on some selected assertions in response to the assessed risk of material misstatements for the year under audit. These assertions were not examined by him in previous years due to materiality or risk considerations.***

    Mr. X leads the internal audit department of the company and reports to the company's audit committee. During the audit, a senior member of the engagement team decides to engage Mr. X to provide direct assistance in performing the above substantive procedures. Comment with respect to the relevant Standards on Auditing.

    Also, indicate the activities to be performed by the statutory auditor prior to using internal auditor for providing direct assistance.

15. ***The management of High Limited is concerned with the reporting requirement cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014 for the financial year 2023-24 with regard to the Audit Trail (edit log). Audit trails may be enabled at the accounting software level depending on the features available in such software or same may be captured directly in the database underlying such accounting software. Consequently, the management of the company approached CA J and asked him to suggest them list of internal controls which may be required to be implemented and operated to demonstrate that the Audit trail (or Edit Log) feature was functional, operated and was not disabled. Guide CA J.***

Answers to Test Your Understanding

1. As per section 138 of the Companies Act, 2013 the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.

    The Board can appoint any professional as may be decided by it. The applicant in question is a law post graduate and he has spent 25 years of his career in Indian Audit & Accounts Service. Therefore, he has got the necessary experience and skills required for the said

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vacancy. The Board would be in a position to appoint such a competent and experienced person in the field of auditing as its Chief Internal auditor.

2. The Internal Auditor does not assume any responsibility to manage or operate the compliance framework or to take compliance related decisions. It is not responsibility of the Internal Auditor to execute or resolve compliance related risks (e.g., engaging directly with regulators, etc.).

Although internal audit function provides independent assurance to enhance governance (which includes compliance with laws and regulations), it does not assume operational responsibility of its compliance framework. It is the responsibility of the management. He is responsible for auditing the compliance framework and not managing it. Similarly, he does not accept compliance related risks like directly engaging with regulator.

3. The greater the judgment needed to be exercised in planning and performing the audit procedures and evaluating the audit evidence, the external auditor will need to perform more procedures directly because using the work of the internal audit function alone will not provide the external auditor with sufficient appropriate audit evidence.

The appropriate use of going concern assumption requires significant judgment on part of statutory auditor.

Therefore, statutory auditor cannot place total reliance on internal auditor's work in this regard and he should perform more procedures directly.

Hints /Answers to Theoretical Questions

1. Refer para 6.

2. **Evaluation of Internal Audit Functions by External Auditor:** The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are:

(a) **Organisational Status -** Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation, his reports to the highest level of management and are free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.

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(b) **Scope of Function -** The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.

(c) **Technical Competence -** The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.

(d) **Due Professional Care -** The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes and working papers.

3. **Applicability of Internal Audit:** Section 138 of the Companies Act, 2013 states that every private limited company is required to conduct internal audit if its outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In view of the above provisions, AB Pvt. Ltd. is mandatorily required to conduct an internal audit as its loans or borrowings are falling under the prescribed limit.

Who can be appointed as Internal Auditor- The internal auditor shall either be a Chartered Accountant or a Cost Accountant, whether engaged in practice or not, or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the companies.

The internal auditor may or may not be an employee of the company.

Work to be reviewed by Internal Auditor- Refer Para 2.

4. Refer Para 7.3.

5. (a) **Direct Assistance from Internal Auditor:** As per SA 610, "Using the Work of Internal Auditor", the external auditor shall not use internal auditors to provide direct assistance to perform procedures that Involve making significant judgments in the audit.

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement.

Significant judgments include the following:

- Assessing the risks of material misstatement;

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- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management's use of the going concern assumption;
- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

In view of the above, Mr. A cannot ask for direct assistance from internal auditors regarding evaluating significant accounting estimates and assessing the risk of material misstatements.

(b) **Direct Assistance from Internal Auditor in case of External Confirmation Procedures**: SA 610, "Using the Work of Internal Auditor", provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned.

Further, in accordance with SA 505, "External Confirmation" the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors. However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

6. HR Head needs to evaluate multiple options and identify the most suitable option in light of the relevant provisions, guidance and overall governance of the organization. HR head also needs to evaluate different options for his administrative reporting and various options for functional reporting of Chief Internal Auditor. The possible options to be considered and evaluated include the Board of Directors, Audit Committee, Managing Director of the Company and Chief Executive Officer or Chief Financial Officer.

As per section 138 of the Companies Act 2013, the internal auditor shall either be a Chartered Accountant or a Cost Accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.

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As per the revised definition of the term 'Internal Audit' as per para 3 of the ICAI's Framework Governing Internal Audits, "Internal audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives".

Refer para 3.1, The Internal Auditor shall be free from any undue influences which force him to deviate from the truth. This independence shall be not only in mind but also in appearance. Also, the internal auditor shall resist any undue pressure or interference in establishing the scope of the assignments or the manner in which these are conducted and reported, in case these deviate from set objectives.

As per the requirement of the above stated provision, Chief Internal Auditor needs to be independent of the operational activities and report of Audit Committee / Board of Directors to enjoy his true status of independent auditor. He may administratively report to CEO or Managing Director for his administrative reporting purpose or any other similar authority till the time it is approved by Board of Directors, and it does not impact his independence to be able to perform his duties and report to audit committee / Board of Director independently.

7. Refer para 2.0.

The internal auditor should, in consultation with those charged with governance, including the audit committee, develop and document a plan for each internal audit engagement to help him conduct the engagement in an efficient and timely manner.

Internal audit plans should be developed in such a manner that all the business processes covering both financial as well as operational activities are reviewed by internal audit function within a defined time cycle. Also, ensuring that appropriate consideration is made, and adequate balance is ensured to the following:

- Risk underlying the business process
- Value that the internal audit can provide to the organization
- Effort involved in conducting the internal audit for a particular business process
- Risk Appetite of the organization
- Coverage of all auditable areas within the defined time range

8. Refer para 5.0.

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9. Refer para 6.0.

As per Standard on Internal Audit (SIA) 370 Reporting Results, reporting of internal audit results is generally undertaken in two stages:

- **At the end of a particular audit assignment**, an "Internal Audit Report" covering a specific area, function or part of the entity is prepared by the Internal Auditor highlighting key observations arising from those assignments. This report is generally issued with details of the manner in which the assignment was conducted and the key findings from the audit procedures undertaken. This report is issued to the auditee, with copies shared with local and executive management, as agreed during the planning phase.

- **On a periodic basis, at the close of a plan period**, a comprehensive report of all the internal audit activities covering the entity and the plan period is prepared by the Chief Internal Auditor (or the Engagement Partner, in case of external service provider). Such reporting is normally done on a quarterly basis and submitted to the highest governing authority responsible for internal audits, generally the Audit Committee. Some part of the aforementioned Internal Audit Reports may form part of the periodic (e.g. Quarterly) report shared with the Audit Committee.

  Accordingly, a typical internal audit report should include the following:

  - Audit Scope performed;
  - Audit period Covered;
  - Executive Summary;
  - Summary of the critical findings;
  - Detailed audit findings with elaboration on business impact and root cause of such issues;
  - Rating of the highlighted issues (E.g High / Medium / Low) in accordance to the rating criteria approved by Audit Committee;
  - Audit recommendation to improve control environment and address the highlighted finding;
  - Response received from the responsible functional authority containing action plan and target timelines for action.

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10. Refer para 6.1.

As per SIA 390 Monitoring and Reporting of Prior Audit Issues, the Chief Internal Auditor is responsible for continuously monitoring the closure of prior audit issues through timely implementation of action plans included in past audits. This shall be done with a formal monitoring process, elements of which are pre-agreed with management and those charged with governance. The responsibility to implement the action plans remains with the management.

In monitoring and reporting of prior audit issues, the responsibility of the Internal Auditor is usually in the form of an "Action Taken Report (ATR) of previous audits".

To address the requirement of Audit Committee in the given situation, Internal Auditor should assess the action taken against the previous audit findings and report a summary of the action taken by the management. Typical Action Taken Report may include the following:

- Reference to the previous audit reporting containing the reported issues
- Implementation Action agreed by the management along with target implementation date
- Status of action taken by management. The same may be classified under Implemented / Not Implemented
- Residual risk and rating for any unimplemented action
- Audit findings not implemented for long period of time
- Any critical audit finding that requires immediate action for action or implementation.

11. As per section 138 of the Companies Act, 2013, following class of companies (prescribed in Rule 13 of the Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(A) every listed company;

(B) every unlisted public company having-

(1) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(2) turnover of two hundred crore rupees or more during the preceding financial year; or

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(3) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(4) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(C) every private company having-

(1) turnover of two hundred crore rupees or more during the preceding financial year; or

(2) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In the given case, XYX Limited is a listed company. As per section 138 of the Companies Act, 2013, every listed company is required to appoint an internal auditor or a firm of internal auditors. Thus, in view of the above, XYX Limited is required to appoint an internal auditor.

Further, MNM Limited is unlisted public company. The company is having ₹ 60 crore as equity share capital which is exceeding the prescribed limit of rupees fifty crore as per section 138. Thus, MNM Limited is required to appoint an internal auditor as per section 138 of the Companies Act, 2013.

GFG Limited is unlisted private company and having ₹ 70 crore as equity share capital, ₹ 180 crore as turnover and ₹ 80 crore loan from Bank and PFI. In view of provisions of section 138 of the Companies Act, 2013 discussed above, all the limits are below the prescribed limit for a private company. Therefore, GFG Limited is not required to appoint an internal auditor.

It can be concluded that XYX Limited and MNM Limited are required to appoint the internal auditor as per the provisions of the Companies Act, 2013 whereas GFG Limited is not required to do the same.

12. (a) In the given case, Rishi notices several discrepancies in the disbursement records and suspects there might be weaknesses in the internal control system. He is concerned about maintaining his independence and objectivity while ensuring that management is aware of these issues.

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Responsibilities of Rishi as an Internal Auditor with respect to the accounting function and financial records of the organisation include:

- *to ascertain adequacy of system of internal control by a continuous examination of accounting procedures, receipts and disbursements, and to provide adequate safeguards against misappropriation of assets.*
- *to operate independently of the accounting staff and must not in any way divest any of the responsibilities placed upon him.*
- *not to involve in the performance of executive functions in order that the objective outlook does not get obscured by the creation of the vested interest.*
- *to observe facts and situations and bring them to notice of authorities who would otherwise never know them; also, critically appraise various policies of the manage-ment and draw its attention to any deficiencies, wherever these require to be corrected.*
- *to associate closely with management and keep knowledge up to date by being informed about all important occurrences and events affecting the business, as well as the changes that are made in business policies.*
- *at all times, the internal auditor must enjoy an independent status.*

(b) *As per SA 610, "Using the Work of Internal Auditor", the external auditor shall not use internal auditors to provide direct assistance to perform procedures that involve making significant judgments in the audit.*

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make significant judgments in the audit engagement.

Significant judgments include the following:

- *Assessing the risks of material misstatement;*
- *Evaluating the sufficiency of tests performed;*
- *Evaluating the appropriateness of management's use of the going concern assumption;*
- *Evaluating significant accounting estimates; and*
- *Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.*

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In view of the above, CA Nitin cannot ask direct assistance from internal auditors regarding evaluating the appropriateness of management's use of the going concern assumption in accordance with SA 610.

13. *In the given situation, CA Sanjana has recently joined as Chief Internal Auditor in Up Scale Limited, a listed company. As a Chief Internal Auditor, CA Sanjana is responsible for continuously monitoring the closure of prior audit issues through timely implementation of action plans included in past audits. This shall be done with a formal monitoring process, elements of which are pre-agreed with management and those charged with governance. The responsibility to implement the action plans remains with the management. In monitoring and reporting of prior audit issues, the responsibility of the CA Sanjana as internal auditor is usually in the form of an "Action Taken Report (ATR) of previous audits". The term "Monitoring and Reporting" refers to the periodic tracking of issues raised during prior audits and evaluation of the corrective actions undertaken by the auditee to resolve them and to report any open and pending matters to the management and those charged with governance.*

CA Sanjana should review whether follow-up action is taken by the management on the basis of his report. If no action is taken within a reasonable time, she should draw the management's attention to it. Where the management has not acted upon the suggestions or not implemented the prescribed recommendations, she should ascertain the reasons thereof.

Where the management has accepted recommendations of the CA Sanjana and initiated the necessary action, she should periodically review the manner and the extent of implementation of the recommendations and report to the management highlighting the recommendations which have not been implemented fully or partly.

14. *SA 610, "Using the Work of Internal Auditor" states that in determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned. Examples of activities and tasks that would not be appropriate to use internal auditors to provide direct assistance include the discussion of fraud risks, determination of unannounced audit procedures as addressed in SA 240 etc.*

In the above case, engagement partner had designed certain substantive procedures on some selected assertions in response to assessed risk of material misstatements in year under audit. Such assertions were not tested by him in the previous years due to materiality or risk considerations. It is being done now for incorporating an element

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of unpredictability in audit procedures to be performed as individuals within the company who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting.

Therefore, in such matters, using an internal auditor to provide direct assistance could prove to be counter-productive and defeat the very purpose of designing such substantive procedures. Hence, decision of senior engagement team member to use Mr. X to provide direct assistance on above said matters is not in accordance with SA 610 and is not proper.

Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall: -

(a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and

(b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

15. Refer para 9.0.

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CHAPTER 17

DUE DILIGENCE, INVESTIGATION & FORENSIC ACCOUNTING



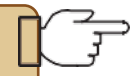
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Know the concept of Due Diligence, Investigation and Forensic Accounting.
- Differentiate between Audit and Investigation.
- Know the steps to be taken at the time of Investigation.
- Understand the purpose of Due diligence and content of its report.
- Gain knowledge of FAIS, Forensic Accounting Investigation Report.

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CHAPTER OVERVIEW



Due Diligence	Investigation	Forensic Acounting
• Purpose • Classification • Work Approach to Due Diligence • Content of Due Diligence Report	• Steps in Investigation • Special Issues in Investigations • Audit V/s. Investigation	• Meaning • Fraud and Procedures • FAIS • Foresnic Accounting Investigation Report

K, a CA final student, was curious about the concepts of "*Due Diligence", "Investigation" and "forensic accounting"*. The terms sounded familiar to him but he lacked knowledge about fine distinctions among these. *"Due Diligence"* broadly means taking care before entering into agreement or transaction with a party which a reasonable person ought to take. Can it be performed by anyone? Of course. It is not an exclusive activity bracketed for Chartered Accountants.

***"Investigation"* is aimed at establishing a fact or a happening or assessing a situation. Reasons for investigation are varied. Like, a Chartered accountant may be engaged to discover whether a fraud has occurred or to conduct an investigation where an entity proposes to buy a business. Its purpose is specific. It is not in the nature of general prudence and care.**

"Forensic accounting"* relates to use of professional accounting skills in matters involving the possibility of fraud to collect relevant evidence and facts which could help support an expert view for *potential or actual civil or criminal litigation. The evidence should be suitable for use in a court of law or before a regulatory body.

K was reading a report about a Surat based company whose forensic accounting was conducted by a firm empaneled by the Indian Banks' Association (IBA). The facts of the company made interesting reading. It was engaged in importing raw diamonds, exporting diamonds after finishing and catering to the domestic market. The company was availing credit facilities amounting to ₹250 crore from a consortium of bankers consisting of 5 banks. The credit facilities consisted of cash credit limit, packing credit limit, Bills purchased limit, LCs issued and term loans. The account was declared NPA due to failure to meet repayment obligations, devolved LCs and overdrawn accounts. The company had also trade transactions with its sister concerns.

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How should Forensic Professional have proceeded with? The approach in forensic accounting is on gathering facts and evidence and a critical examination of all the evidence with respect to violations. It includes review of data over period of time to identify red flags and use of computer assisted techniques to find digital evidence stored in the system. Review of documentation and gathering market intelligence is next crucial step. Interviews with identified employees can be of great help.

It would also include answer to the questions like whether funding availed by the company from banks was required. It may turn out that the credit requirements of the borrower were not assessed properly, and the company was provided credit facilities disproportionate to its requirements. It would require analysis of PCL and bills purchased facilities to understand the purpose. There may be forex transactions not in accordance with imports and exports. Transactions with sister concerns would require to be analysed for probable fund diversion and siphoning off. It would help in digging out trails for end use of funds.

He was surprised to learn that Standards exist in this field too. Forensic Accounting and Investigation Standards (FAIS) enhance the quality of forensic accounting and investigation services rendered by Chartered Accountants.

1. DUE DILIGENCE REVIEW

Due Diligence is used to investigate and evaluate a business opportunity, verify Agreements, encumbrances on the assets, Assets – their title and ownership, intellectual Property, Health, Safety and Environment Laws, etc. It implies a general duty to exercise care in any transaction. Most legal definition of due diligence describes it as a measure of prudence activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance, not measured by any absolute standard but depends on the relative facts of the special case.

Due diligence is a process of investigation, performed by investors, into the details of a potential investment such as an examination of operations and management and the verification of material facts. It entails conducting inquiries for the purpose of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction. Due diligence involves a careful study of the financial as well as non-financial possibilities for successful implementation of restructuring plans.

Due diligence involves an analysis carried out before acquiring a controlling interest in a company to determine that the conditions of the business conform with what has been presented about the target business. Also, due diligence can apply to recommendation for an investment or advancing a loan/credit.

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Due Diligence may also be required to be performed in cases of corporate restructuring, venture capital financing, lending, leveraged buyouts, public offerings, disinvestment, corporatisation, etc. Sometimes, in a restructuring exercise, while the unit may remain within a group, it may pass from under the charge of one management team to that of another team. This situation also gives rise to the need for a due diligence review.

One such emerging area is around mandatory human rights and environmental due diligence. The OECD Due Diligence Guidance for Responsible Business Conduct (RBC) set out the expectation that how an enterprises can carry out risk-based due diligence. Under OECD RBC due diligence standards, enterprises are expected to carry out risk-based due diligence to identify, prevent, mitigate and account for how they address actual and potential adverse impacts to people, society and the planet.

DIFFERENCE BETWEEN DUE DILIGENCE AND AUDIT

It needs to be underlined that due diligence is different from audit. An audit is an independent examination and evaluation of the financial statements of an organization with a view to express an opinion thereon. Whereas due diligence refers to an examination of a potential investment to confirm all material facts of the prospective business opportunity. It involves reviewing financial and non-financial records as deemed relevant and material. In essence, due diligence aims to take the care that a reasonable person should take before entering into an agreement or a transaction with another party.

2. IMPORTANCE OF DUE DILIGENCE

When a business opportunity first arises, it continues throughout the talks, initial data collection and evaluation commence. Thorough detailed due diligence is typically conducted after the parties involved in a proposed transaction have agreed in principle that a deal should be pursued and after a preliminary understanding has been reached, but prior to the signing of a binding contract.

The purpose of due diligence is to assist the purchaser or the investor in finding out all the care that a reasonable person can, about the business he is acquiring or investing in prior to completion of the transaction including its critical success factors as well as its strength and weaknesses.

In addition, it may expose problems or potential problems that can be addressed in the price negotiations or by dealing suitable clauses in the contractual documentation, in particular, warranty and or indemnity provisions.

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There are many reasons for carrying out due diligence including:
To confirm that the business is what it appears to be;
To identify potential 'deal killer' defects in the target company and avoid a bad business transaction;
To gain information that will be useful for valuing assets, defining representations and warranties, and/or negotiating price concessions; and
To verify that the transaction complies with investment or acquisition criteria.

3. CLASSIFICATION OF DUE-DILIGENCE

Due Diligence can be sub-classified into discipline-wise exercises in following manner:

(i) **Commercial/Operational Due Diligence**: It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.

(ii) **Financial Due Diligence**: It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.

(iii) **Tax Due Diligence**: It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. The accountant has to look at the tax effect of the merger or acquisition.

(iv) **Information Systems Due Diligence**: It pertains to all computer systems and related matter of the entity.

(v) **Legal Due Diligence**: This may be required where legal aspects of functioning of the entity are reviewed.

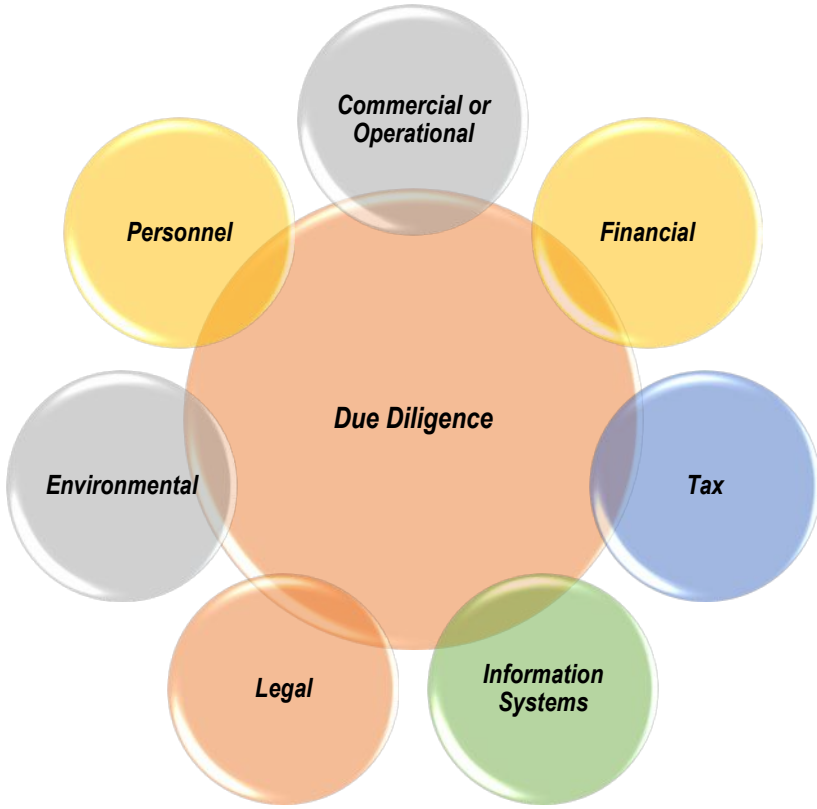


1. The legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.

(vi) **Environmental Due Diligence**: It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.

(vii) **Personnel Due Diligence**: It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.

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Financial Due Diligence

At times, the financial due diligence review is interpreted as a complete due diligence review since it is supposed to ascertain the financial implications of all the other due diligence reviews. This is, however, not appropriate. The term 'financial due diligence' should be used with caution. Unless the scope of financial due diligence to be performed is wide enough to cover all the aspects, it should not be confused with overall due diligence review.

It can be understood from the foregoing that the role of financial due diligence commences only after a price has been agreed for the business or a restructuring plan is framed. The initial price and other decisions are taken based on net worth as well as trend of profitability of the target company, with an assumption that all contingent liabilities that may impact the future of the business have been recorded. The principal objective of financial due diligence, therefore, is usually to look behind the veil of initial information provided by the company and to assess the benefits and costs of the proposed acquisition/merger by inquiring into all relevant aspects of the past, present and future of the business to be acquired/merged with.

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In order to achieve its objective, the due diligence process can include any or all of the following objectives for individual areas of the verification:

- Brief description of the history of business
- The background and standing of promoters
- Accounting policies and practices followed by the organization
- Management information systems
- Details of management structure
- Trading results both past and the recent past
- Assets and liabilities as per latest balance sheet
- Current status of Income tax assessments including appeals pending against tax liabilities assessed by tax authority.
- Cash flow patterns
- Brief description of commercial and/or other activities carried out by the organization
- The projection of future profitability

If a full-fledged financial due diligence is conducted, it would include the following matters, *inter alia*, in its scope:

(a)	Brief history of the target company and background of its promoter;	(b)	Accounting policies;
(c)	Review of financial statements;	(d)	Taxation;
(e)	Cash flow;	(f)	Financial Projection;
(g)	Management and employees;	(h)	Statutory Compliance.

(a) Brief history of the target company and background of its promoters - The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters.

The details of how the company was set up and who were the original promoters has to be gone into, before verification of financial data in detail. An eye into the history of the target company may reveal its turning points, survival strategies adopted by the target company from time to time, the market share enjoyed by the target company and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the target company. Broadly, the accountant

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should make relevant enquiries about the history of target's business products, markets, suppliers, expenses, operations. This could, inter alia, include the following:

- Nature of business(es)



2. Manufacturer/ trader, wholesaler,
financial services, import/export.

- Location of production facilities, warehouses, offices.
- Employment



3. By location, supply, wage levels, union contracts, pension commitments, government regulation.

- Products or services and markets



4. Major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes.

- History of the business with important suppliers of goods and services



5. Long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time".

- Inventories



6. Locations,
Quantities.

- Franchises, licenses, patents.
- Important expense categories.
- Research and development.
- Foreign currency assets, liabilities and transactions.
- Legislation and regulation that significantly affect the entity.
- Information systems.

(b) Accounting policies - The accountant should study the accounting policies being followed by the target company and ascertain whether any accounting policy is inappropriate.

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The accountant should also see the effects of the recent changes in the accounting policies. The target company might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale.

The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at any material effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should have a detailed look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target company, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target company are different from those adopted by the acquiring enterprise, the effect of such differences.

(c) Review of Financial Statements - Before commencing the review of each of the aspect covered by the financial statements, **the accountant should examine whether the financial statements of the target company have been prepared in accordance with the Statute governing the target company, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards**. If not, the accountant should record the deviations from the above and consider whether it warrant an inclusion in the final report on due diligence.

After having an overall view of the financial statements, as mentioned in the above paragraphs, **the accountant should review the operating results of the target company in great detail**. It is important to make an evaluation of the profit reported by the target company. The reason being that the price of the target company would be largely based upon its operating results.

The accountant should consider the presence of an extraordinary item of income or expense that might have affected the operating results of the target company.

It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. This comparison could lead the accountant to the reasons behind the variations. It is important that **the trading results for the past four to five years are compared and the trend of normal operating profit arrived at.**

The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business.

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In the case of many enterprises, the valuation is mainly based on the value of net worth only. For valuation of immovable properties and plant, if required, the assistance of expert valuers could also to be taken. The exercise to evaluate the balance sheet of the target company has to take into consideration the basis upon which assets have been valued and liabilities have been recognised. The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities. The accountant should pay particular attention to the valuation of intangible assets.

The objective of the Due Diligence exercise will be to look specifically for any hidden liabilities or over-valued assets.



7. Hidden Liabilities:

- The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- The company may have given "Letters of Comfort" to the banks and Financial Institutions. Since these are not "guarantees", these may not be disclosed in the Balance sheet of the target company.
- The Company may have sold some subsidiaries/businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer. These may not be reflected in the books of accounts of the company.
- Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation.
- Tax liabilities under the direct and indirect taxes.
- Long pending sales tax assessments.
- Pending final assessments of customs duty where provisional assessment only has been completed.
- Agreement to buy back shares sold at a stated price.
- Future lease liabilities.
- Environmental problems/claims/third party claims.
- Unfunded gratuity/superannuation/leave salary liabilities; incorrect gratuity valuations.
- Huge labour claims under negotiation when the labour wage agreement has already expired.
- Unresolved labour litigations

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8. Over-Valued Assets:

- Uncollected/uncollectable receivables.
- Obsolete, slow non-moving inventories or inventories valued above NRV, huge inventories of packing materials etc. with name of company.
- Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
- Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- Litigated assets and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.
- Infructuous project expenditure/deferred revenue expenditure etc.
- Group Company balances under reconciliation etc.
- Intangible assets of no value.

(d) Taxation - Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. The accountant has to also look at the tax effects of the merger or acquisition.

(e) Cash Flow - A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time.

It is necessary to check that:

(a) Is the company able to honor its commitments to its trade payables, to the banks, to government and other stakeholders?

(b) How well is the company able to turn its trade receivables and inventories?

(c) How well does it deploy its funds?

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(d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(e) What is the investment pattern of the company and are they easily realisable?

(f) Financial Projections - The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask the target company to give projections on optimistic, pessimistic and most likely bases.



9. The accountant evaluates the appropriateness of assumption used in the preparation and presentation of financial projections. If the accountant is of the opinion that as assumption used by the target company is unrealistic, the accountant should consider its impact on the overall valuation of the company. He should offer his comments on all the assumptions, highlighting those which, in his opinion are not inappropriate. In case he feels the projections provided by the target company are not achievable or aggressive he has to mention this in his report. He should thoroughly check the arithmetical accuracy of the calculations made for financial projections.

(g) Management and Employees - In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these matches the requirements of the new incumbents. Due to the complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce, and it is important to gauge the likely impact of such litigation.



10. It is important to see if all employee benefits like Provident Fund (P.F.), Employees State Insurance (E.S.I.), Gratuity, leave and Superannuation have been properly paid/ provided for/funded. In case of un-funded Gratuity, an actuarial valuation of the liability has to be obtained from a reputed actuary.

The assumptions regarding the increase in salaries, interest rate, retirement etc. have to be gone into to see if they are reasonable. It is also necessary to see if the basic salary /wage considered for the valuation is correct and includes all elements subject to payment of Gratuity. In the case of PF, ESI etc. the accountant has to see if all eligible employees have been covered.

It is very important to consider the pay packages of the key employees as this can be a crucial factor in future costs. One has to carefully look at Employees Stock Option Plans; deferred compensation plans; Economic Value Addition and other performance linked pay; sales incentives that have been promised etc. It is also important to identify the key employees who will not continue after the

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acquisition either because they are not willing to continue or because they are to be transferred to another company within the 'group' of the target company.

(h) Statutory Compliance - During due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws/ statues that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

TEST YOUR UNDERSTANDING 1

CA Y is employed with a leading private sector BDFP Bank posted in Noida branch. One of the existing borrowers has approached the branch with a proposal to sanction fresh term loan of ₹5 crore with commensurate increase in working capital credit facilities relating to expansion of its garment manufacturing unit. While performing due diligence, he notices that the company was formed just two years ago and had availed term loan of ₹ 10 crore and cash credit facilities of ₹5 crore respectively. Its sales have increased from ₹ 25 crores in the first year to ₹45 crores in the year just ended. It is generating cash profits and is timely servicing its debts.

The borrower was catering to the domestic market earlier. However, now it is in the process of procuring export orders and working diligently in this regard. The expansion plans are in line with development in the area of marketing relating to exports.

However, there are a large number of units catering to domestic and export market of garments in Noida, Delhi and surrounding areas. There is also a demand slump in the biggest US market.

Besides, the unit is family-based and relies upon the marketing skills of its main promoter. There is lack of well-paid qualified staff with the borrower to deal effectively with its customers both domestic as well as foreign.

He starts jotting down and elaborating above points. Identify what he is trying to do as part of due diligence.

4. WORK APPROACH TO DUE DILIGENCE

The purchase of business in many instances is the largest and most expensive assets purchase in lifetime and therefore some caution should be exercised through the due diligence process. Therefore, assessing the businesses' fair value passes through.

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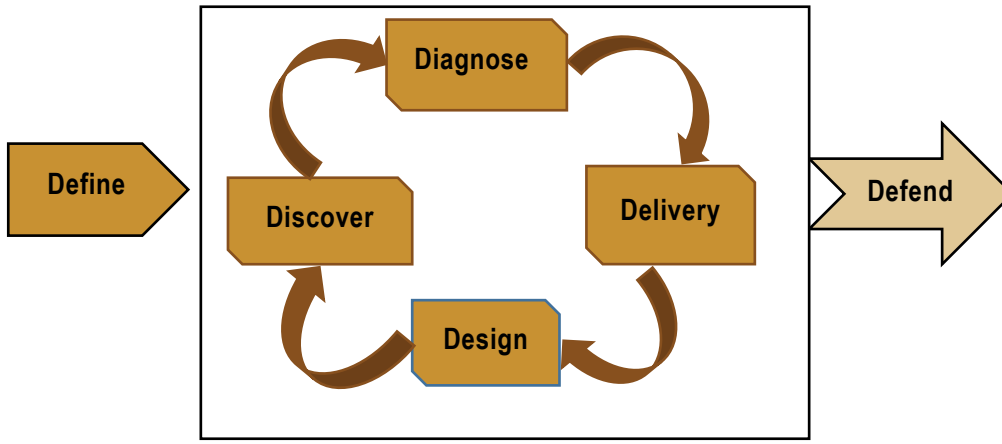
Reviewing and reporting on the financials submitted by the target company.

Assessing the business first hand by a site visit (if applicable).

Working through the due diligence process with the acquisitioning company or investor by defining the key areas.

Helping prepare an offer based on completion of due diligence.

Discovering the correct strategy is always challenging, and even more so during challenging economic circumstances. Each situation is unique. The variables are numerous, including factors such as company age, markets, geography, price levels, competitive dynamics, to name but a few. But when a company and its products are turned to match market needs and expectations-that is, the decision makers and influencers involved in purchase decision-exceptional changes in performance can occur. However, comprehensive model that describes this approach to the work is illustrated in the figure below:



5. HOW TO CONDUCT DUE DILIGENCE

- Start with an open mind. Do not assume that anything wrong will be found and look for it. What needs to be done is to identify trouble spots and ask for explanations.
- Get the best team of people. If you do not have a group of people inside your firm that can do the task (e.g. lack of staff, lack of people who know the new business because you are acquiring a business in an unrelated area, etc.), there are due diligence experts that you can hire. When hiring such professionals, look for their experience record in the industry.

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- Get help in all areas like finance, tax accounting, legal, marketing, technology, and any others relevant to the assignment so that you get a 360-degree view of the acquisition candidate.
- Talk to customers, suppliers, business partners, and employees are great resources.
- Take a risk management approach. So, while you want to do your research, you also want to make sure that you do not antagonise the team of people of the target company by bogging them down with loads of questions.
- Prepare a comprehensive report detailing the compliances and substantive risks/issues.

6. CONTENTS OF A DUE DILIGENCE REPORT

The contents of a due diligence report will always vary with individual circumstances. Following headings are illustrative:

Example of Headings of a Due Diligence Report
♦ Executive Summary
♦ Introduction
♦ Background of Target company
♦ Objective of due diligence
♦ Terms of reference and scope of verification
♦ Brief history of the company
♦ Share holding pattern
♦ Observations on the review
♦ Assessment of management structure
♦ Assessment of financial liabilities
♦ Assessment of valuation of assets
♦ Comments on properties, terms of leases, lien and encumbrances.
♦ Assessment of operating results
♦ Assessment of taxation and statutory liabilities
♦ Assessment of possible liabilities on account of litigation and legal proceedings against the company

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♦ Assessment of net worth
♦ Interlocking investments and financial obligations with group / associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account
♦ SWOT Analysis
♦ Comments on future projections
♦ Status of charges, liens, mortgages, assets and properties of the company
♦ Suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities
♦ Suggestions on various aspects to be taken care of before and after the proposed merger/acquisition.

7. INVESTIGATION



The term investigation implies a systematic and in-depth examination or inquiry to establish a fact or to evaluate a specific situation. In other words, investigation means "inquiry into facts". Professional accountants are often required to investigate the accounts or the related matters and records of the enterprise. The term investigation may be defined as an examination of books and records preliminary to financing or for any other specified purpose, sometimes differing in scope from the ordinary audit. Thus, investigation covers areas of financing decisions, investment decisions, fraud or profitability determination or cost determination etc.

7.1 Audit versus Investigation

Investigation differs substantially from an audit assignment. Audit aims at collection of sufficient appropriate audit evidence to enable the auditor to form a judgement and express an opinion on the financial statements or other data under examination. An investigation, on the other hand, requires special in-depth examination of the particular records or transaction with the objective of establishing a part or happening or assessing a particular situation. The scope of audit is broad based and general in nature whereas investigation is narrow and specific.

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The difference is tabulated below:

Basis of Difference	Investigation	Audit
(i) Objective	An investigation aims at establishing a fact or a happening or at assessing a particular situation.	The main objective of an audit is to verify whether the financial statements display a true and fair view of the state of affairs and the working results of an entity.
(ii) Scope	The scope of investigation may be governed by statute, or it may be non- statutory.	The scope of audit is wide and in case of statutory audit the scope of work is determined by the provisions of relevant law.
(iii) Periodicity	The work is not limited by rigid time frame. It may cover several years, as the outcome of the same is not certain.	The audit is carried on either quarterly, half-yearly or yearly.
(iv) Nature	Requires a detailed study and examination of facts and figures. Investigation is voluntary in nature.	Involves tests checking or sample technique to draw evidence for forming a judgement and expression of opinion. It is mandatory for companies.
(v) Inherent Limitations	No inherent limitation owing to its nature of engagement.	Audit suffers from inherent limitation.
(vi) Evidence	It seeks conclusive evidence.	Audit is mainly concerned with prima- facie evidence.
(vii) Observance of Accounting Principles	It is analytical in nature and requires a thorough mind, capable of observing, collecting and evaluating facts.	Is governed by compliance with generally accepted accounting principles, audit procedures and disclosure requirements.
(viii) Appointing Agency	Even third party can appoint Investigator	Auditor is appointed by owner/ shareholders of company/ enterprise
(ix) Reporting	The outcome is reported to the person(s) on whose behalf investigation is carried out.	The outcome is reported to the owners of the business entity.

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The approach to an investigation is different from that followed in an audit. An investigation involves a more detailed examination of the selected areas than what is required in an audit. An investigation seeks substantive and, in some of the cases, even conclusive evidence as compared to audit which mainly relies on persuasive evidence.

An investigator does not accept a stated fact as correct until it is substantiated. An auditor, in the absence of suspicious circumstances, relies on stated facts or figures. An auditor has to see whether the method of valuation and other accounting policies have been properly made in the financial statements or not. An investigator, however, is not bound by accounting conventions, policies and disclosure requirements. An auditor does not suspect unless circumstances are there to arouse suspicion, while an investigator approaches the work with a frame of mind to suspect, verify and satisfy.

The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe: fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the prima facie findings of the auditor.

8. STEPS IN INVESTIGATION

As investigation involves a variety of situations, it is not possible to lay down any standardised procedure. However, usually, an investigation requires the following steps in order of sequence:

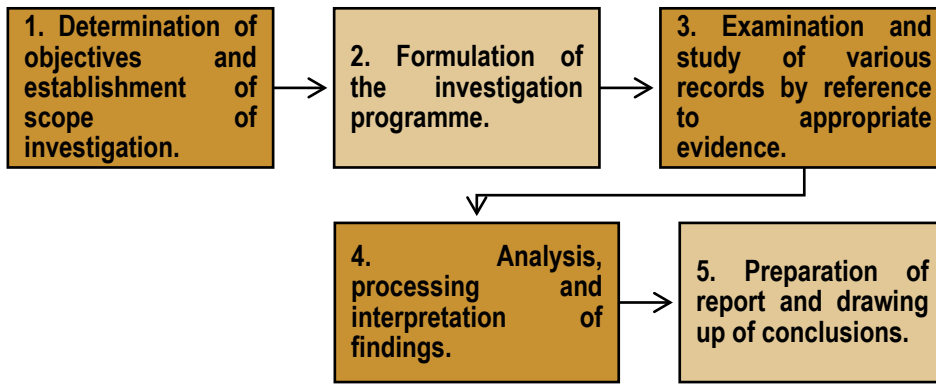


Diagram showing Sequence of Steps for Investigation

Step 1: Determination of objectives and establishment of scope of investigation

At the stage of acceptance of the assignment, the investigator should be absolutely clear about what is sought to be achieved by the investigation. If instructions from the client leave matters vague and

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non-specific, it would be proper for the investigator to have the matters discussed and obtain clearly written instructions covering the object, the scope and purpose of investigations and the issues incidental thereto.

The period to be covered under investigation should be clearly specified. The results of investigation are often seriously affected owing to changes in circumstances which have occurred since it was contemplated, e.g., devaluation, import restrictions, starting of a new division, etc. Therefore, the purpose of the investigation should be borne in mind while determining the period which an investigation should cover.

Step 2: Formulation of the investigation programme

It is not possible to draw up one programme to serve different types of investigations which a professional accountant is called upon to carry out, for their scope and content have to be determined on a consideration of circumstances peculiar to each business or situation. The investigation programme should be drawn up having regard to:

(a) The nature of the business.

(b) The structure of business organization.

(c) The instructions from the client embodying the objectives and scope of work.

(d) The consequent scope and depth of investigation.

(e) The necessity to extend the investigation into books and records belonging to others.

(f) The investigator should concentrate on areas considered relevant rather than to undertake a wide-ranging verification.

The programme should also be flexible so that knowledge gained with the progress of work can be used to extend, reduce or modify the extent and areas of checking.



11. In case of an investigation on suspected payment of wages to ghost workers, the investigator should scan the areas having a bearing on the determination of wages and payments thereof. He should concentrate on time and job cards, appointment and terminatio of workers, attendance records, internal controls, internal checks, and preparation of wage sheets, withdrawal of money from bank for payment of wages and the actual disbursement of wages.

A conscious effort in investigation programming should be devoted to localise the enquiry into the relevant areas and, for that purpose, the initial wider base of inquiry should be gradually narrowed

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and fixed at a level that is meaningful. Matters not found to have a bearing on the subject matter of investigation should be gradually and progressively eliminated. This procedure alone will enable an in-depth examination of the matters relevant to the investigation.

Step 3: Collection of Evidence

Through examination, the investigator would be gathering relevant evidence connected with the matters to be investigated. In the course of examination of the documents and records, the investigator may require to obtain oral explanations from various personnel of the concerned business. In case his client is a person external to the business, it may be necessary for the investigator to get the matter formally agreed to by the business through the client. The investigator should look for the most convincing evidence; he should seek and examine all the available evidence and by a process of elimination and corroboration, should endeavour to reach at the truth of the matter. He, unlike the auditor, is not to restrict himself to *prima facie* evidence ordinarily available. He should examine it and if circumstances demand should try to obtain evidence that may have to be specifically procured. The investigating accountant can take help of external experts/ persons like, related parties outside the organization, valuation experts etc. to obtain specific evidence. Further, the work of investigating accountant should ensure that the process of obtaining evidence does not interfere with the regular work of client.



12. In the matter of valuation of land, he should definitely have regard to the available evidence as per records of the business and records of any bid received for the land. In addition, he should have regard to the prices at which land was sold or purchased in the neighbourhood around the same time. This may require him to obtain evidence even by going to the land registration office. He may also call for the report of experts in land valuation.

Step 4: Analysis and Interpretation of Findings

Careful analysis and correlation of facts and figures will be necessary before the investigator can reach his conclusion. The conclusion should be well reasoned, backed by established facts and evidenced by proper records/ data. He must analyse the data objectively on the basis of evidence gathered by him and should not draw conclusions according to pre-conceived notions. While interpreting the figures, the investigator must keep in mind various factors e.g. the political and economic considerations, competition faced by the business, historical pattern of the data, nature of the business, etc. The interpretation should be brief, clear and free from doubts.

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Step 5: Reporting of findings

Like all other work of an accountant, an investigation results in a report. It is submitted and addressed to the party at whose instance the investigation has been carried out. The nature of the report is governed mainly by two factors –

(a) The instructions given by the client as regards the special aspects of the business which are required to be investigated;

(b) The findings of the investigating accountant/ investigator.

The important issues to be kept in mind by the investigator while preparing his report are as follows:	
(i)	The report should not contain anything which is not relevant either to highlight the nature of the investigation or the final outcome thereof.
(ii)	Every word or expression used should be properly considered so that the possibility of arriving at a different meaning or interpretation other than the one intended by the investigator can be minimized.
(iii)	Relevant facts and conclusions should be properly linked with evidence.
(iv)	Bases and assumptions made should be explicitly stated. Reasonableness of the bases and assumptions made should be well examined and care should be taken to see that none of the bases and assumptions can be considered to be in conflict with the objective of the investigation. For example, in an investigation into over-stocking of raw materials, inventories and spares etc. it should not be assumed that the ordering levels indicated on bin cards provide fair guidance about acquisition of further materials. Also, since investigation is a fact-finding assignment, assumptions should be made only when it is unavoidably necessary.
(v)	The report should clearly spell out the nature and objective of the assignment accepted its scope and limitations, if any.
(vi)	The report should be made in paragraph form with headings for the paragraphs. Any detailed data and figures supporting any finding may be given in Annexures.
(vii)	The report should also state restrictions or limitations, if any, imposed on the instructions given by the client. Preferably the reasons for placing such restrictions and their impact on the final result should also be stated.
(viii)	The opinion of the investigator should appear in the final paragraph of the report.

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Due to non-availability of standardised procedure and lack of professional guidance, investigation calls for extreme care, caution and circumspection on the part of the investigator in exercising his judgement and discretion. Investigation often has a characteristic of very intimate and direct involvement of parties whose interest may be affected. Therefore, unlike auditing, chances of one or the other of the parties challenging the finding of the investigation are far greater.

9. SPECIAL ISSUES IN INVESTIGATIONS

Investigations broadly range between two extremes; on the one hand there are those in respect of which complete accounts, documents, records and other information are available, and on the other, those in respect of which little information, besides published accounts and statistical data, is available. Then again, investigation may cover the whole of accounting or may relate to only a part or parts of accounting as may be specified. Some more issues often arise in investigation. They are stated below:

(a) **Whether an investigator is required to undertake a cent per cent verification approach or whether he can adopt selective verification -** The answer to this question depends on the exact circumstances of the case under investigation. If the investigator has to establish the amount of cash defalcated by the cashier, he has probably no option but to carefully examine all the cash vouchers and related records. On the other hand, if he is to arrive at the profitability of a concern, he may verify constituent transactions on a selective basis taking extreme care to see that no material transaction that affects profit has remained concealed from his eyes. In investigation, it is always safer to go by statistically recognised sampling methods than to depend on the so-called "test checks" where circumstances permit selective verification.

(b) **Whether the investigator can put reliance on the already audited statement of account-** Here also no dogmatic views are possible. If the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises. However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put reliance on audited materials made available to him unless, in the course of his test verification, he finds the audit to have been carried on very casually or unless his terms of appointment clearly require to test everything afresh.

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It was held in the case of Short & Compton v. Brackert (1904) that an accountant, when making an investigation for an incoming partner, was entitled to assume that the figures appearing in the books were correct.

In another case, Mead v. Ball Baker & Co. (1911), it was held that an accountant, when acting as an adviser to a proposed investor in a limited company, was not expected to check errors in stock sheets and the omission of liabilities.

These cases were decided a long time ago. Therefore, much reliance cannot be placed on them. It is, therefore, desirable for the investigator to ascertain from the client, in advance, in writing, whether the audited statements of account produced to him should be taken as correct.

If the statements of account produced before the investigator were not audited by a qualified accountant, then of course there arises a natural duty to get the figures in the accounts properly checked and verified. However, when the accounts produced to the investigator have been specially prepared by a professional accountant, who knows or ought to have known that these were prepared for purposes of the investigation, he could accept them as correct relying on the principle of liability to third parties settled in the famous Hedley Byrne's case. Nevertheless, it would be prudent to see first that such accounts were prepared with objectivity and that no bias has crept in to give advantage to the person on whose behalf these were prepared.

(c) **Whether an investigator necessarily requires assistance of expert -** Often an investigator may feel the necessity of obtaining views and opinions of experts in various fields to properly conduct the investigation. It would be therefore, proper for the investigator to get the written general consent of his client, to refer special matters for views of different experts at the beginning of investigation and he should settle the question of costs for obtaining the views and other related implications.

(d) **Investigation out of disputes and conflicting claims -** Cases for investigation sometimes arise out of disputes and conflicting claims. It is needless to highlight that the investigator should remain above disputes or conflicting claims and be alert to the possibilities of the information or documents made available to him to be prejudiced. Even the client, overtly or covertly, may try to influence his reports. A seller of a business or controlling shares may request him to see that he gets the most favourable price. Similarly, if he is appointed by the buyer, he may be requested to deliberately depress the value. The investigator should keep him scrupulously professional and should keep the interest of all the involved parties in view.

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This is a challenging task and probably no other professional work offers this much of challenge. This work is exciting too and requires not only the best of skill but of a high degree of maturity and experience.

(e) **Basis of opinion of an investor-** The investigator should refrain from issuing speculative opinion. He should confine his opinion to the established facts and nothing more. If the facts, as conveyed through the books, records, papers and other evidence, are not capable of being properly established, he should not express an opinion or, if at all he expresses any opinion, he should qualify the opinion by clearly stating the reasons therefor. This problem may particularly arise in cases where incomplete books and records are produced for investigation.

(f) **Whether an investigator can make futuristic statements – Even if the appointing authority is willing to obtain a futuristic statement,** the investigator should refuse to be futuristic. He may assume that the established trend in the business will continue in the near future, in the absence of any contrary evidence, in arriving at the present value of a business. He, however, should not project the trend into any future years to establish a value.

(g) **Whether to retain working papers or not -** Another important precaution is that the investigating accountant should retain in his files full notes of the work carried out, copies of schedules and all working papers, annexures, facts, figures, record of conversations and the like. Also, the working papers should link the figures as shown by the books of business with the final figures produced by the investigating accountant. Wherever required the investigator should take representation letter from the appointing authority. In the absence thereof, he would not be able to explain the figures when he is called upon to give evidence in a court of law to support his figures; for quite often the conclusions of the accountant are challenged by parties whose interest is adversely affected by his findings, for example, when the value of shares of a company taken over by the Government has been determined by him. This will also be of immense help to the investigator in correlating facts and events and later in drafting the report.

10. SPECIAL ASPECTS IN CONNECTION WITH BUSINESS INVESTIGATIONS

We discuss below the factors to be considered by a professional accountant while carrying out the investigation for attaining satisfactory results:

(a) **Studying the overall picture -** In such a business investigation, it is of utmost importance first to have an overall picture of the position of the business which is being investigated before the

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details are gone into. This is because figures are only symbols; and it is impossible to interpret them intelligently without knowledge of the background in which they have emerged.



13. For investigating the accounts of a group of companies, it would not be possible to know the manner in which the profits had emerged in the past unless a chart is prepared, showing the relationship of different companies comprising the group; whether as subsidiaries or not, the nature of transactions entered into by one unit in the group with another or others and the terms on which this has been done. Further, it is important to know whether the business is engaged in the manufacture of one or two important lines of products, is principally processing materials or is concerned only with the sale of a single product. Also, whether it is a business which depends for its success on imported raw materials or supply of parts and components from ancillary businesses or uses indigenous materials and parts which are manufactured locally.



14. If the business is labour-intensive, its future profitability would be dependent on the availability of skilled labour and relations of the management with the trade unions. Labour relations thus can affect the future profitability of the business. The method of distribution of products, either through wholesalers or retailers, also must be examined. Apart from these preliminary enquiries, the investigating accountant should study:

(i) the character of management;

(ii) the economic and political forces to which the business is subject; and

(iii) the position it enjoys in the market as against its competitors.

At times, political or economic factors also may affect the fortunes of a business; for example, labour disturbances, changes in government policies in the matter of levy of excise and custom duties, imports, etc. It is, therefore, necessary that the impact of all these factors should be studied and their effect on the business judged on a consideration of the profits in the past. For studying the economic and financial position of the business, the following should be considered:

(i) The adequacy or otherwise of fixed and working capital. Are these sufficient for the growth of the business?

(ii) What will be the trend of the sales and profits in the future? Establishing the trend of sales, product-wise and area-wise will ordinarily help in drawing a conclusion on whether the trend will be maintained in the future.

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(iii) Whether the profit which the business could be expected to maintain in the future would yield an adequate return on the capital employed?

(iv) Whether the business is operating at its 100 percent capacity or improvements can be made to reach at full productivity?

(b) Statement of Profit and Loss - To study the Statement of Profit and Loss of a concern, it is necessary to consider each item, included therein, in relation to the corresponding items in the Statement of Profit and Loss of the previous years. It is, therefore. necessary that a summary, in columnar form, should be prepared of the balances included in the Statement of Profit and Loss of the business for a period, say, of 5 to 7 years.

In the foregoing summary, in the place of figures of opening and closing inventories, the figures of inventory consumed, for each product, in different years should be entered. It should also be verified that the inventories have been valued on a consistent basis throughout the period under review. If there has been a change, the values of inventories should be adjusted. Further, in the summary, the gross profit ratios and the ratios showing the relationship between various items of expenses and sales should be entered. The trend of these ratios should be examined and, if there is a wide divergence in them, an explanation for the same should be sought. In the preparation of the summary attention should also be paid to the following matters:

Turnover - The figures of sales should be broken down between the various products sold to show variations in turnover of individual products from year to year. In this way, it would be possible to find out the products the sales of which have been increasing and those the sales of which have been falling.

By reference to the list of customers, in the Order Books, it should be ascertained whether the business has a very large turnover with a few customers or a small turnover with several customers.

The Order Books should also be examined to find out if fictitious sales have been entered in any year to boost up profits. If so, the figures of sales of the year or years should be adjusted.

If the business consists of activities which are dissimilar in operation, like manufacturing and agency, then apart from splitting the income between the two sources, expenses should also be apportioned between them to separately arrive at the figures of profit from each of the activities.

Wage structure - The method of computing wages and the rates of wages should be examined. On occasions a business may have to pay higher wages than those prevailing in other business in the same neighborhood in pursuance of an industrial award. Another factor which is important to consider in this connection is the relationship of the business with its workers/ labour unions. A business which has suffered several industrial disputes, strikes, etc. and has had its working

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interrupted by them frequently cannot be expected to prosper unless a proper settlement is reached with workers' unions.

Depreciation and Maintenance - The charge on account of depreciation and maintenance of machinery and other assets included in the accounts of different years should be compared to verify that depreciation has been provided from year to year on a consistent basis and that it is adequate. Also, the necessary adjustment in the depreciation charge should be made if it is the practice of the company to write off the assets on a renewal basis.

Further, if assets have been revalued, it should be confirmed that depreciation on the increased valuation has been adjusted. Generally, with age, the cost of maintenance of assets should increase. If it has not, the reason thereof should be ascertained.

In case of leasehold property, it should be ascertained whether an adequate provision has been made for the dilapidation charge which may be payable at the end of the lease.

Further, compliance of relevant AS should also be verified.

Managerial Remuneration - It should be verified that the remuneration payable to various members of managerial personnel is not excessive in relation to the profits of the business after taking into account the time devoted by each of them. However, it could also be that no or only a nominal remuneration has been charged in the accounts. In either case, an adjustment should be made to arrive at true profitability of the concern. Further, in case of company, requirement of relevant section of the Companies Act, 2013 is to be seen. It has to be assured that calculation of profit for arriving at the remuneration is correct.

Exceptional and **non-recurring items -** It is customary to adjust exceptional items in the summary of Statement of Profit and Loss in order that they may not obscure the trend of the profits. In the matter of non-recurring items, it is necessary to remember that adjustments are to be made in respect of exceptional items which do not recur from year to year or can be considered exceptional having regard to their materiality or periodicity.

In this connection, it is worthwhile to examine the income tax assessment orders of the business to find out the items which have been treated as revenue but have been considered inadmissible by the taxing authority. Where the effect of these has been abnormal on the tax paid by the company from year to year, suitable adjustments should be made in the figures of taxes paid, as well as in the assets amounts. Likewise, adjustments should be made in respect of exceptional profits and losses like, profit or loss on sale of obsolete asset.

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Repairs and maintenance - It is one of the recurring expenses of a business. Occasionally it is noticed that this expenditure is unduly heavy in some of the years, while quite low in some others. Generally, companies, as a matter of routine undertake major repairs, overhauls and maintenance programme at an interval of 3 or 4 years while running repairs and maintenance continue in the usual manner which gives rise to fluctuating charges in the accounts unless periodic major expenses are treated as deferred expenditure.

Besides, due to wrong allocation of expenses between capital and revenue, repair charges may appear to be heavy or low. If fluctuating and abnormal charges for repairs is noticed, it would be the duty of the investigating accountant to scrutinise this head thoroughly to establish correct and normal charge for repairs.

Unusual year - A company's record of profitability may show a trend of increasing or decreasing profit or loss or it may be highly erratic and fluctuating. Where a definite trend is discernible, the job of the investigating accountant is somewhat simplified. He can adopt recent years' record of profitability as the basis for estimating future maintainable profit having regard to the inflationary state in the economy. But if the same is fluctuating, there would be more demand on judgement of the accountant in selecting the period to be covered for estimation of profitability. In such cases it may even be necessary to take into consideration results of past 9 to 10 years with a view to iron out the fluctuation. If, however, it is noticed that results of one or more years under scrutiny were materially vitiated by exceptional factors like a long-term industrial dispute, natural calamities, pandemic, fire, war, ravage etc., the investigating accountant should eliminate such year / years from consideration altogether since they do not reflect the results obtained through normal business.

(c) Balance Sheet - Fixed Assets - Fixed assets, usually, are shown in accounts at cost less depreciation but the accounts do not show the ages of different assets. It is desirable, therefore, to obtain age analysis of various items of fixed assets. Assets which are old or are obsolete would naturally have to be replaced. It should be seen that their values are not in excess of the value of service that they could be expected to render to the business during the balance period of their active life and the amount they would fetch on sale as scrap. Title deeds should be verified to ascertain the extent of enterprise's ownership in such assets, like land and building jointly owned by two or more companies or their subsidiaries.

In addition, from a study of the maintenance expenses incurred from year to year, it should be judged whether the assets have been properly maintained. If not, it might be necessary to incur heavy expenditure on repairs to put them in a proper working order. In such a case, an allowance for this factor should be made in the value of assets. More particularly, it should be seen that if ass ets have been revalued, the increased depreciation charge has been adjusted against profit. Further,

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investigator has to assure whether assets whose recoverable amount is less than carrying amount are impaired and requirement of AS 28, "Impairment of Asset", has been complied.

Investments -Investments should be broadly classified into long term investments and current investments. A current investment is by its nature readily realisable and is intended to be held for not more than one year. All other investments are long term investments.

Current investments are valued on the basis of lower of cost and fair value determined either on an individual investment basis or by category of investment but not on an overall basis.

Long-term investments are usually carried at cost. However, when there is a permanent decline in the value of long-term investments, the carrying amount should be reduced to recognise the decline. The carrying amount of long-term investments is determined on an individual investment basis. Interest, dividends and rentals receivable in connection with investment are generally regarded as income. However, in some cases, such receipts represent recovery of cost and should therefore be reduced from, the cost of investment (e.g. dividend out of pre-acquisition profits).

Inventories - It should be seen that inventories have been valued consistently and that the basis of valuation was such that the value placed on inventories did not include any element of profit. Also, there should be due allowance for damaged, obsolete and slow-moving inventories. In some cases, physical verification of inventories is necessary where the inventories belonging to the entity are held by other parties. Examine the appropriateness of valuation of work in progress as disclosed in the books.

Trade Receivables - In assessing their value, the following should be taken into account:

(i) Whether provision for bad debts have been made in the years in which the relevant sales took place instead of in the year in which they have been written off, except when debts have had to be written off on account of a slump or a fall in international prices, during a period subsequent to the period in which sales had taken place.

(ii) The length of the credit period allowed or any excessive discounts allowed throughout the period under investigation, to determine whether it has been necessary to increase continually the credit period in order to affect the sales. If it has been so, it would indicate that the demand for the goods manufactured by the concern in the market has been diminishing gradually.

(iii) Debts should be classified according to their age. This would disclose the character of the parties with whom the company trades and the amount of working capital that will be necessarily blocked on this account in the course of business. Determine Debtors to Sales Ratio.

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Other liquid assets - It should be ascertained that the assets so described are readily realisable. Money with a bank in liquidation should be taken only to the extent guaranteed by Deposit Insurance Scheme.

Idle assets -On a scrutiny, it may appear that certain assets are remaining idle and are not being properly applied in the business. These may come from all sections of assets. For example, certain plant and machinery may have been put to use after a considerable period of time after acquisition. Some of the fixed assets may be awaiting installation even at the valuation time. The company may hold large cash and bank balances, not warranted by the need of the business. Then again, there may be instances of obsolete and slow-moving inventories of large value in the accounts of the company. It would be the duty of the investigating accountant to eliminate these idle assets, if any, after proper identification from the net worth of the business. However, proper value of these assets may be separately added to the value of the business.

Liabilities - The important matter to investigate in this regard is whether those are stated fully or understated or overstated. In other words, whether the profits of the business have been inflated by suppression of liabilities or there are any free reserves included in the liabilities. In either case, an adjustment would be necessary. Secondly, it should be ascertained that liabilities are not unduly large or are not outstanding for a long time, in such cases, it would be necessary to pay off some of them which would cause a drain on the liquid resources of the concern. The fact should be stated in the report.

Taxation - Orders in respect of assessments completed should be studied and it should be verified that an adequate provision has been made in respect of liabilities for taxes which have not been assessed. Also, it should be seen that in the past there has been no reopening of assessments. If so, the company may be liable for an undisclosed sum of taxes plus penalties. Any temporary tax benefit should also be disregarded.

Capital - In this regard, it is necessary to ascertain:

(i) Whether the capital is well balanced. This would not be the case if the number of debentures and preference share capital are disproportionately large as compared to the equity capital. Low equity capital would handicap the company in raising further equity capital, on favourable terms for financing the business or to pay off capital commitment. Further, when the capital is highly geared, it would affect the value of the equity capital;

(ii) That the amount of capital is reasonable compared to the value of fixed assets and the amount of working capital required. The terms associated with the issue of the capital should

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also be studied; restriction on transferability of shares usually depresses the value of share and of the business.

(d) Interpretation of figures - Fixed Assets - The amount of capital expenditure which would be necessary in the future for the continuation of the business, in its existing stage, should be assessed having regard to the under-mentioned factors:

(i) the amount required for the replacement of assets when these would become worn out or obsolete;

(ii) the expenditure which will be necessary to replace obsolete machinery by more sophisticated machinery for manufacturing different types of goods for which there is demand.

Turnover - In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

(i) Trend: Whether in the past sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.

(ii) Marketability: Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.

(iii) Political and economic considerations: Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

(iv) Competition: What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

Working Capital - In making assessment of the working capital requirements in the future, the following matters should be taken into account:

(i) Has the ratio of inventory to turnover been increasing and if so, is it a continuing or only a temporary trend?

(ii) Are the trade payables being paid promptly or is there a backlog which will have to be dealt with?

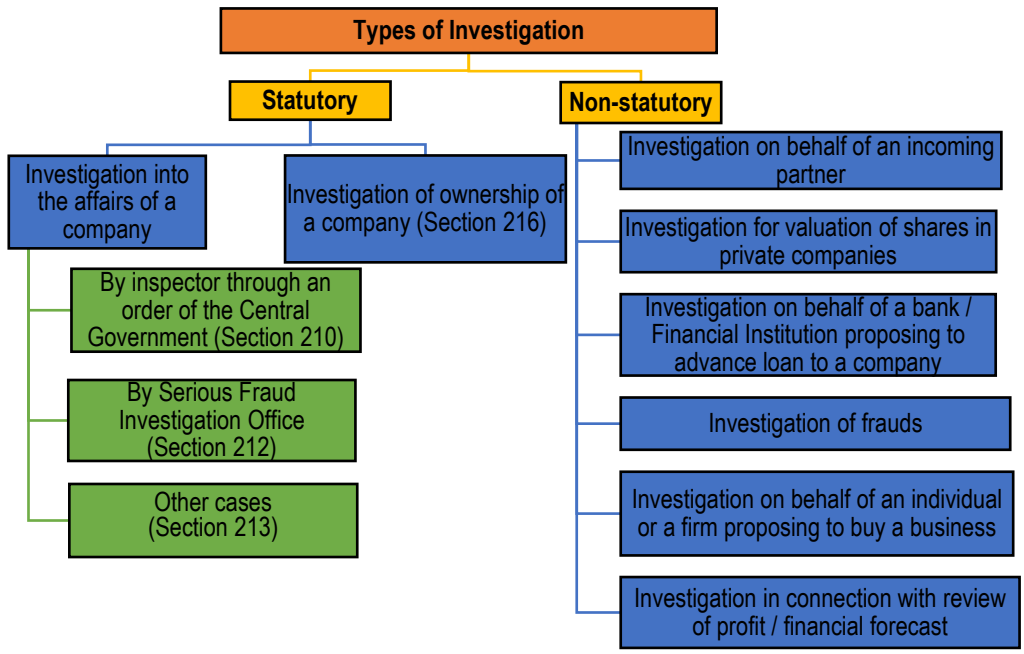
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(iii) What will be the effect on inventory, trade receivables and trade payables, if the turnover is increased or if new products are introduced?

Estimating Future Maintainable Profits - Fluctuations in profits during the years under review should be examined after adjusting the profits for extraneous factors, if any, that had given rise to fluctuations to determine whether the factors responsible for the fluctuations were temporary or was likely to recur in future. A statement should be prepared showing separately the profits after depreciation earned in each of the years during the period under review, after making adjustments therein, if considered necessary, as regards factors which have been responsible for any extraordinary increase in profits. If the percentage of profits before taxation to capital has been stable or has been increasing, it would indicate that the business would continue to earn the same rate of profit as it has done in the past. If, on the other hand, the percentage has been falling, and there is no evidence that the factors responsible therefore have ceased to operate, investment of further capital in the business would not be commercially advisable.

11. TYPES OF INVESTIGATION

The different types of investigation that a chartered accountant is usually called upon to carry out are given hereunder:



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Statutory - By an inspector under Sections 210, 212, 213 and 216 of the Companies Act, 2013 – discussed in detail in Self-Paced Module Set A.

Non-statutory - These are listed as under:

(a)	Investigation on behalf of an incoming partner.
(b)	Investigation for valuation of shares in private companies.
(c)	Investigation on behalf of a bank proposing to advance loan to a company.
(d)	Investigation of frauds.
(e)	Investigation on behalf of an individual or a firm proposing to buy a business.
(f)	Investigation in connection with review of profit/financial forecast.

11.1 Investigation on behalf of an Incoming Partner

The general approach of the investigating accountant in this type of investigation would be more or less similar, irrespective of the nature of business of the firm-manufacturing, trading or rendering a service.

Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital contribution, personal capability of the existing partners, socio-economic setting, etc., and whether he would be capable of deriving continuing benefit by the way of return on capital to be contributed and remuneration for services to be rendered, which can be justified by the overall economic conditions prevailing and other considerations considering his own personality and achievements. In addition, he would be interested to ascertain whether the capital to be contributed by him would be safe and applied usefully.

Broadly, the steps involved are the following:

(a)	Ascertainment of the history of the inception and growth of the firm.
(b)	Study of the provisions of the deed of partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, financial management, goodwill, etc.
(c)	Scrutiny of the record of profitability of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature of partners' remuneration, which may be excessive or inadequate in relation to the nature and

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	profitability of the business, qualification and expertise of the partners and such other factors as may be relevant.
(d)	Examination of the asset and liability position to determine the tangible asset backing for the partner's investment, appraisal of the value of intangibles like goodwill, know how, patents, etc. impending liabilities including contingent liabilities and those pending for tax assessment. In case of firms rendering services, the question of tangible asset backing usually is not important, provided the firm's profit record, business coverage and standing of the partners are of the acceptable order.
(e)	Position of orders at hand and the range and quality of clientele should be thoroughly examined, which the firm is presently operating.
(f)	Position and terms of loan finance would call for careful scrutiny to assess its usefulness and implication for the overall financial position; reason for its absence or negative impact should be studied.
(g)	It would be interesting to study the composition and quality of key personnel employed by the firm and any likelihood of their leaving the organisation in the near future.
(h)	Various important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full impact of such standing agreements would be gauged before a final decision is reached.
(i)	Reasons for the offer of admission to a new partner should be ascertained and it should be determined whether the same synchronises with the retirement of any senior partner whose association may have had considerable bearing on the firm's success.
(j)	Appraisal of the record of capital employed and the rate of return. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure, if any, envisaged along with the admission of the partner.
(k)	It would be useful to have a firsthand knowledge about the specialisation, if any, attained by the firm in any of its activities.
(l)	Manner of computation of goodwill on admission as also on retirement, if any, should be ascertained.
(m)	Whether any special clause exists in the deed of partnership to allow admission in future of a new partner, who may be specified, on concessional terms.
(n)	Whether the incomplete contracts which will be transferred to the reconstituted firm will be a liability or a loss.

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It would always be worthwhile to remember that, in a partnership, personal considerations count predominantly over other considerations and assessment of standing of the firm, standing and reliability of other partners, their personal reputation and the goodwill enjoyed by the products/services of the firm are important.

On the basis of the broad frame of considerations as given above, the investigating accountant should devise his own considerations in each case which may be quite diverse. Additional considerations may come up in the case of service-rendering firms where profit and business record, goodwill of the firm and of individual partners would assume greater significance.

Again, in the case of industrial firms, the network of customers, their scatter, size, etc., would be relevant for consideration.

11.2 Investigation for Valuation of Shares in Private Companies

The importance should be given on various purposes for which such a valuation is necessary, the different bases on which valuation is possible and the variety of economic factors, on a consideration whereof the price so determined needs to be adjusted.

The necessity for valuation of shares of a private company arises, for under the Companies Act,2013 a private company must restrict the transfer of its shares. In consequence, the shares of a private company do not have a free market in which their prices could be determined by interaction of the forces of supply and demand.

In respect of equity shares, there are two main methods of valuation. According to the *first* method, value is determined on the basis of the net worth of the company. The amount of net worth is divided by the number of shares comprising the equity capital to arrive at the value for one share. When this method is followed, goodwill of the business, and non-trading assets (like investments) based on the estimated future maintainable profit, is included among the assets to arrive at the amount of net worth. According to the *second* method, the average profit earned by the business during the preceding 5 to 7 years is computed. Afterwards, on the assumption that the same would continue to be earned in the future, the value of business is calculated by capitalising it at a reasonable rate of interest. If the rate assumed is high, the value of the business would be smaller. Correspondingly, it would be high if the rate of interest applied is low. A provision of the risk factor and restriction on transfers in the value of shares is made by varying the rate of interest applied. The rate of return that an investor expects to earn in a business of the type in which the company is engaged, is ascertained from the prices of the shares of companies engaged in a similar business quoted on the stock exchange.

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The value of preference shares is estimated on the basis of the yield on preference shares of companies engaged in a similar trade or industry after making allowance for factors like restriction on transferability, average rate of earnings as compared to the rate of dividend, etc.

Special features -

Net worth basis

(a) Each asset should be revalued by taking into account its utility to the business as a going concern. The value of different assets, on a revaluation, may be either more or less in comparison to their book values.



16. The book value of safes and furniture in the case of a bank is usually much less as compared to their utility. On the other hand, the book value of intangible assets, e.g., leasehold rights, patents, goodwill, etc., in case of an industrial concern may be higher in comparison with the advantage which accrues to it from these assets. In both the cases, the assets should be revalued at their replacement cost i.e., the cost of similar assets at the prevailing market price, reduced by the amount of depreciation which they would have suffered, if they were in use during the period that the corresponding assets have been in use. But the cost adopted, in cash, should be the cost of the assets as were originally purchased or that of their substitutes considered more suitable in the circumstances of the case.

(b) The value of goodwill of a business is primarily dependent on its capacity to earn super-profit and the period over which these are expected to arise. The super profits that the business would earn in the future are estimated on the basis of profits earned in the past, after making an allowance therein for the continuation or otherwise of favourable factors, which in the past had enabled the business to earn super-profits. This is usually a difficult matter since, for the purpose, it is necessary to analyse the trend of economic, social and political forces which have an impact on the profitability of the business.



17. The installed capacity must be viewed against future national requirements on taking into account the government's licensing policy. Again, government policies like controls over selling price or advantages of marketing through its own organisations will have to be considered since any change therein might seriously affect the profit structure. Therefore, to determine the impact of these factors, the accountant must have knowledge of the company's working and experience of the business in general.

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Yield basis

(a) The value of shares on yield basis is arrived at on the basis of present value of the right to receive dividends in the future. Since dividends can be paid only out of profits, in this case also, it is necessary to determine the amounts of profits which the company would be earning in future as well as the amounts thereof which would be distributed as dividend from year to year. In short, it is an exercise of projecting the trend of profits and predicting the policy that the company might follow in the matter of declaration of dividends.

(b) The rate at which the amount of dividends should be capitalised is decided on taking into account the risk that shareholders are taking in the matter of declaration of dividends being continued in future, assessed in the background of past history of the company, the amount of reserves the company possesses, both secret and those disclosed in its books, future prospects of the line of manufacture or trade in which the company is engaged and the impact of various social and political factors that are likely to emerge on the company's profitability. Since the effect of these factors is reflected in the prices at which the shares of companies engaged in similar trades and businesses are quoted on the Stock Exchange, the investigating accountant should consider them. This would help him to know the rate at which their dividends were being capitalised. He should adopt the average rate of return expected by investors in the shares of such companies but it should be applied only after making due allowance for the factors peculiar to the case, such as restrictions on transfer of shares, majority holding, etc. In any valuation of shares, with the transfer of shares control is also to pass, a separate value should be ascertained for the control and added to the value otherwise obtained either on net worth basis or yield basis.

11.3 Investigation on behalf of a Bank/ Financial Institution Proposing to Advance/Loan to a Company

A bank is primarily interested in knowing the purpose for which a loan is required, the sources from which it would be repaid and the security that would be available to it, if the borrower fails to pay back the loan. **On these considerations, the investigating accountant, in the course of his enquiry, should attempt to collect information on the under-mentioned points:**

(i)	The purpose for which the loan is required and the manner in which the borrower proposes to invest the amount of the loan.
(ii)	The schedule of repayment of loan submitted by the borrower, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they

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	are reasonable and valid in the circumstances of the case. Institutional lenders now-a-days rely more, for repayment of loans, on the annual profits and loss, and on the values of assets mortgaged to them.
(iii)	The financial standing and reputation for business integrity enjoyed by directors and officers of the company.
(iv)	Whether the company is authorised by the Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used.
(v)	The history of growth and development of the company and its performance during the past 5 years.
(vi)	How the economic position of the company would be affected by economic, political and social changes that are likely to take place during the period of loan.
(viii)	Whether any loan application to any other Bank or Financial Institution was made, and if so, the reasons for rejection thereof.

To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, the investigating accountant should take the under-mentioned steps:

(a) Prepare a condensed income statement from the Statement of Profit and Loss for the previous five years, showing separately therein various items of income and expenses, the amounts of gross and net profits earned, and taxes paid annually during each of the five years. The amount of maintainable profits determined on the basis of foregoing statement should be increased by the amount by which these would increase on the investment of borrowed funds.

(b) Compute the under-mentioned ratios separately and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:

(i) Sales to Average Inventories held.

(ii) Sales to Fixed Assets.

(iii) Equity to Fixed Assets.

(iv) Current Assets to Current Liabilities.

(v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.

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(vi) Equity to Long Term Loans.

(vii) Sales to Book Debts.

(viii) Return on Capital Employed.

(c) Enter in a separate part of the statement the break-up of annual sales product-wise to show their trend.

Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(a) **Fixed assets -** A full description of each asset its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(b) **Inventory -** The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

(c) **Trade Receivables, including bills receivable -** Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

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Further, the total amount outstanding at the close of the period should be segregated as follows:
(i) debts due in respect of which the period of credit has not expired;
(ii) debts due within six months; and
(iii) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

(d) **Investments -** The schedule of investments should be prepared. It should disclose the date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(e) **Secured and Unsecured Loans -** Debentures and other secured loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed. Details of loans proposed to be obtained from Promoters/ Directors/ Related Parties should be stated separately. In case any unsecured loan is to be repaid prior to repayment of Bank loan, its terms and conditions should be verified.

(f) **Provision of Taxation -** The previous year's up to which taxes have been assessed or assessment order received should be ascertained. If provision for taxes not assessed appears to be inadequate, the fact should be stated along with the extent of the shortfall.

(g) **Other Liabilities -** It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.

(h) **Insurance -** A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.

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(i) **Contingent Liabilities -** By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced for example, those of machinery suppliers and the legal adviser. The investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

11.4 Investigation of Frauds

In the Companies Act, 2013 meaning of fraud has been considered in two specific sections viz. Section 143(10), where the SAs specified by the ICAI are deemed to be the auditing standards for purposes of the Act, which, inter alia, define fraud, and in Section 447, where punishment for fraud has been prescribed.

Fraud has been defined in paragraph 11(a) of SA 240, "The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements" as 'an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.'

In the context of stating the provisions for punishment for fraud, Section 447 of the Act has explained the term 'fraud' as "fraud in relation to affairs of a company or any body corporate, includes any act, omission, concealment of fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss."

This Section further explains the terms 'wrongful gain' and 'wrongful loss' to mean the gain by unlawful means of property to which the person gaining is not legally entitled; and the loss by unlawful means of property to which the person losing is legally entitled, respectively.

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11.4.1. Types of Frauds

Frauds may broadly be categorized as –

Fraudulent Financial Reporting	Misappropriation of Assets	Corruption
✓ Alteration or falsification of records & documents ✓ Misrepresentation in or intentional omission of events, transactions or information ✓ Intentional misapplication of accounting principles ✓ Fictitious Journal Entries ✓ Adjusting assumptions and changing Judgments ✓ Omitting, advancing or delaying the recognition of events or transactions. ✓ Abnormal Year End Transactions. ✓ Improper Asset Valuation ✓ Overstatement of Revenue or Understatement of Liabilities	✓ Embezzlement of receipts in respect of written-off accounts – Skimming or Cash Larceny ✓ Stealing physical assets or intellectual properties ✓ Introduction of fictitious vendors ✓ Payroll Schemes – Ghost Employees, Falsified Wages, & Commission Schemes ✓ Reimbursement Schemes – Mischaracterised Expenses, Multiple Reimbursement, & Fictitious Expenses ✓ Using entities assets for personal use.	✓ Conflict of Interest ✓ Bribery ✓ Illegal Gratuities ✓ Money Laundering

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Fraudulent Entries

- Late entry
- No entry
- Part entry
- Inserting wrong entries to divert attention

Sales Frauds

- Price enhancement
- Omission to make receipt of sale of scrap.
- Billing and sales reversals in amusement parks.
- Food production yield ratio in hotels and suppression of Revenue.
- Using or hiring assets of the company in lean period
- Omission in preparation of dispatch note for sale
- Sale of Assets recorded as Income
- Cash sale adjusted as credit sale.
- Writing off a good debt as bad & irrecoverable

Collection Frauds

- Defalcation of contributions to charity funds
- Crediting donation to loan accounts.
- Rental collected in cash but not recorded.

Expenses Frauds

- Entering ineligible discount
- Overcharging expenses
- Falsification of documents
- Untimely payment
- Introduction of fictitious vendor.
- Unnecessary/ huge provisioning of expenses.

Payroll Frauds

- Extra number of employees
- Extra hours
- Calculation of net pay by transferring rounding off amount to personal account.
- Not deactivating the retired employees' IDs
- Fictitious employees/ workers paid salary.

Data Frauds

- Change in computer data
- Destroy, suppress or insert records
- Using open fields in computerized accounting system

Technology related Frauds

- Employing hostile Software Programs or malware attacks
- Phishing mails
- Vishing – Voice Mail
- Smishing - Text messages
- Whaling – Targeted phishing on high network individuals
- Card duplications
- Stealing confidential data

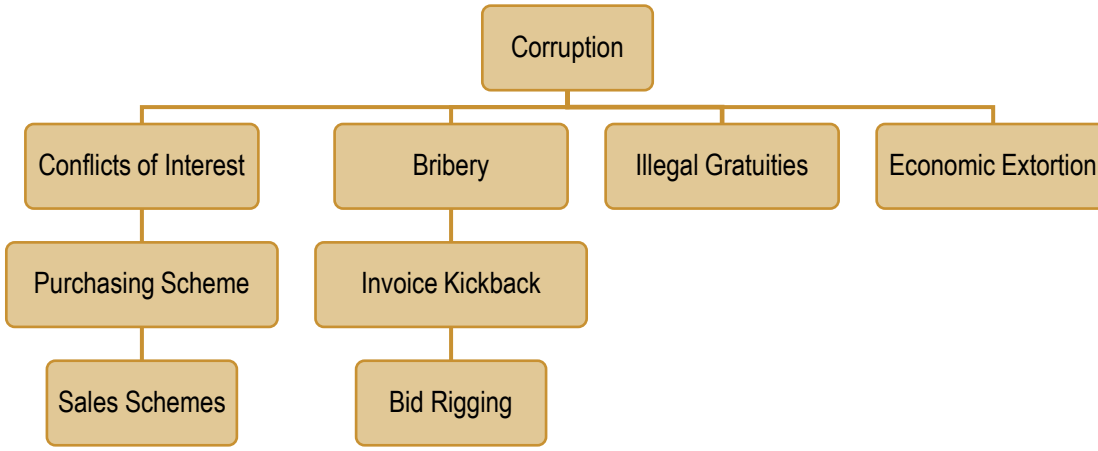
Banking related Frauds

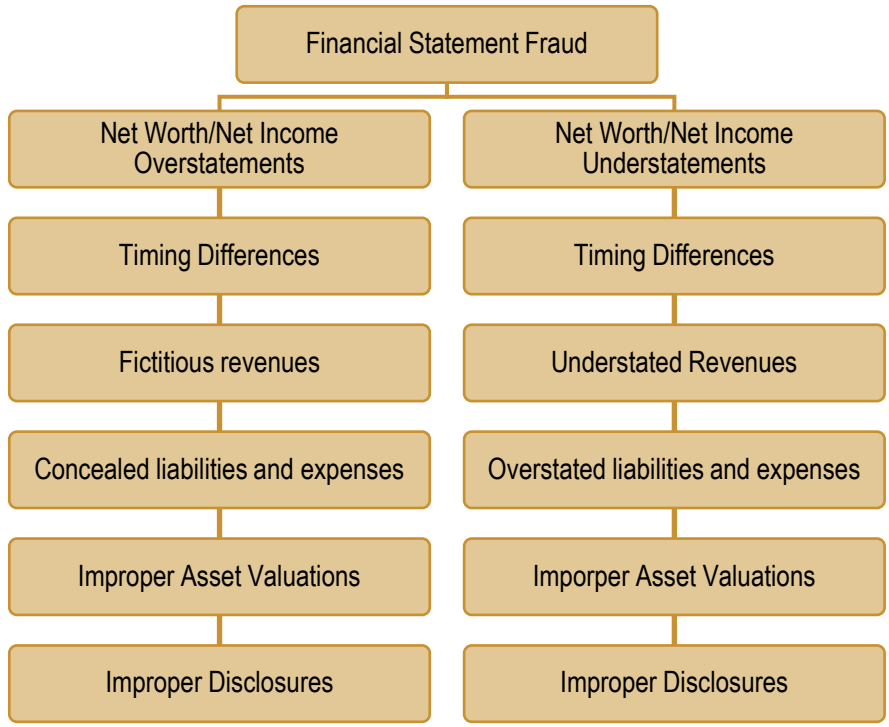
- Forged Signatures
- Cheque Frauds - Alteration in amounts, Alteration in accounts titles, Kite flying
- Cash lending during working hours
- Missing notes in bundles
- Use of same notes bundles by two branches
- Wrong posting in other accounts
- Misuse of sensitive stationery
- ATM transaction misuse
- Using PINs of debit card/credit card holder
- Advances - inflated stock statements, inflated projections, forged/duplicate land documents, L/Cs

Others

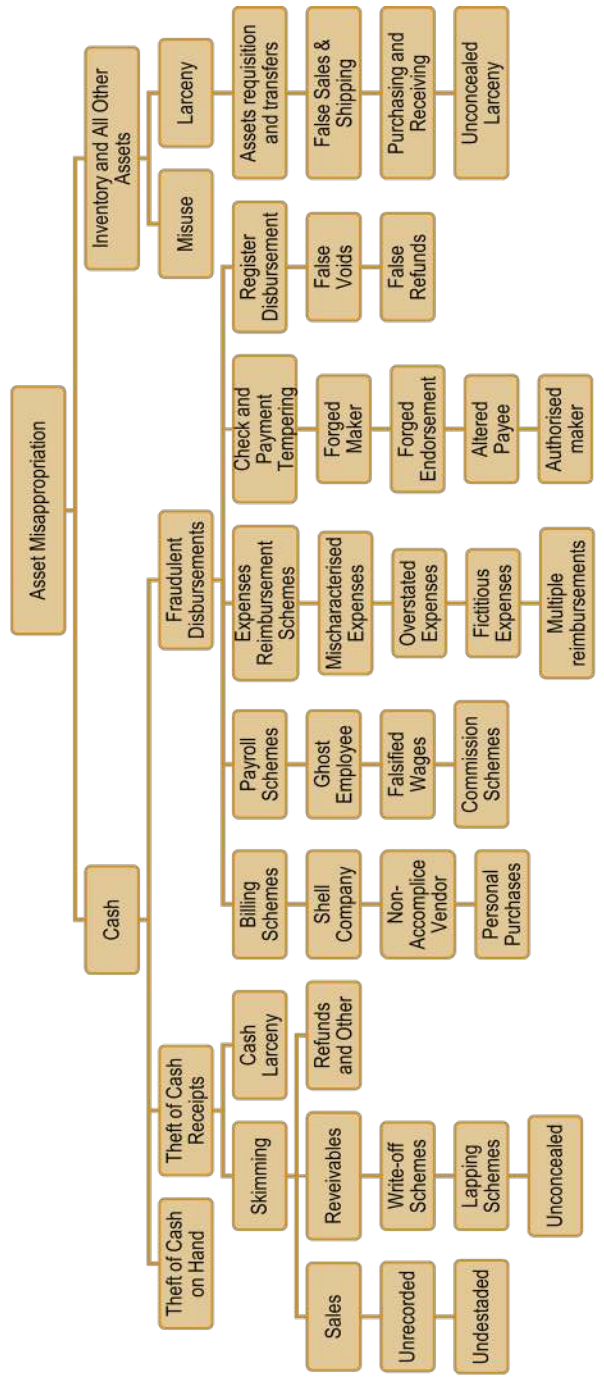
- Teaming and Lading
- Process houses mixing inferior quality material to sale good quality material
- Pilferage and theft in super markets
- Selling classified information,
- Withholding information from customer about free product schemes, discount and concession.
- Enhancement of performance
- Taking advantage of disaster or natural calamity.
- Trust FDs
- Fictitious journal entries to inflate expenses or income.

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Source: Occupational Fraud 2022: A Report to the Nations

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Frauds may be classified as defalcations involving misappropriation, either of money or that of goods, and manipulation of accounts not involving a defalcation. The detections of manipulations of accounts being one of the objects of an audit, for the detection of frauds perpetrated for misappropriating either money or goods, knowledge of the various circumstances under which these may be committed and that of different forms they take is essential. On this account, a brief description thereof at different level is given below:

1. Fraud for Personal Gains

Bribery: Money, gift or other favours offered to procure (often illegal or dishonest) action or decision in favour of the giver. These are also relatable to contract fraud or procurement fraud and are, generally, out of books transactions. The auditor normally conducts a propriety audit over the veracity of the transactions and review of any undue favours to vendors.

When money, gift or other favours are offered to public official to influence an official act of government then such kind of Bribery is called Official Bribery. In contrast to Commercial Bribery or favours to vendors, in case of Official Bribery, Company usually is criminally prosecuted.

2. Corporate Frauds/ Irregularities

(i) Advance Billing: Advance billing is a situation where the company officials indulge in booking fictitious sales in anticipation of actual sales. This results in misrepresentation of revenue in the books thereby misleading financers and stakeholders. When the management treats borrowings from money lenders as customer advances in the books against sale orders or for adjusting bills receivables, the fraudulent act gets unnoticed for an extended period. This situation results in a death knell for the corporation as the company is dragged into an irredeemable debt trap.

Use of Shell Company, false vendors, purchases of personal nature booked as official expenses enable falsification of accounts and diversion of funds for purposes other than an intended purpose. These could also be mechanism for employees or cartel of employees engaging in personal gain at the cost of the company. In the former incident this could be termed as management fraud.

(ii) Shell/ Dummy Company Schemes: Generally, represents a fictitious company or a 'paper company' to transfer profits or funds from the main company. This could also involve fictitious bills (mostly for services rendered or consultancy charges that cannot be corroborated) which are used in the name of dummy companies diverting the funds taken from banks and financial institutions.

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The books could be falsified by wrong classification of expenses, inflating the expense claims, fictitious expenses or multiple reimbursements. A review of controls, normally, leads to the uncovering of expense booking that are prima facie not incurred.

(iii) **Money-Laundering Activities:** As per the Prevention of Money-Laundering Act, 2002, "whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money-laundering."

The person indulging in money laundering looks for avenues with weak banking controls for converting illegal money into the banking system. Any excess credit in the bank accounts that does not belong to the customer or is parked for a temporary period should raise suspicion of such activities. This person indulging in money laundering activity looks for avenues to enter into 'benami' (could be called 'proxy' name lending) transactions. Companies with extensive cash handling and inadequate control over source of money or involved in remittance of money for import/ export of goods etc. are susceptible to money laundering activities.

3. Fraud at Operational Level Employees

(i) **Tampering of Cheques/Drafts/On-line payments/receipts:** Tampering of cheques, payee name being altered, or preparation of cheques without the same being issued to payee, etc., are methods that may also lead to falsification of accounts.

On-line payments generally are considered a transparent mechanism to prevent the above frauds. The ATM is a popular technological advancement that has inherent control gaps. For example, credit cards once swiped the transaction is put through in the system without the need for a signature of the payer. Similarly, unauthorised credits in bank accounts through ATMs are an immense source of threat to recipients including bribery allegations, unless they lodge a complaint with the bankers or the regulatory authorities in a prompt manner of such unauthorised credits to their accounts/or company bank accounts.

Care should be taken that the name of the payee in the payment transactions in books and cheque issued therein for payment is not fabricated to wrongly codify and book against an improper account head.

(ii) **Off Book Frauds:** In off book frauds, the fraud perpetrator misappropriates the cash before these are recorded in the books or before the sale is recorded in the books.

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These frauds are difficult to unearth as the cash or collection is taken off before the accounting entries are made in the books. This situation arises especially in unorganized markets and in rural economies where banking habits are relatively under developed. These are difficult to establish due to absence of audit trails and are more prevalent in businesses that have extensive cash dealings. These are difficult to uncover as the means adopted could include printing of receipts/ bills outside the system.

The above fraudulent schemes can be established based on circumstantial evidence or validation through external sources such as, customer balance confirmations (where feasible) and customer copy of the receipts or other documents that are retained by them. These are also further supplemented by external evidence in the form of background checks and surveillance mechanism. Verification of all the receipts and issues of stock recorded in stock register is another way to identify this type of fraud.

(iii) **Cash Misappropriation:** Cash is misappropriated after the accounting entries are already passed in the books. These are identified through surprise checks and through shortages in cash balances. These occur when there are delays in accounting of cash collections and there are no laid down cash flow controls. Unaccounted money in any form in an entity is a serious red flag in uncovering of irregularities. Improper daily fund monitoring mechanism is another factor that results in creating unauthorised float by employees in their personal account or in fictitious surrogate (proxy) entities by fraudsters.

(iv) **Teeming and Lading:** This is also achieved through cash deposits or cheques collected from customers being overlapped with the collections from subsequent customers and the amount collected is diverted to personal account. Reconciliation of customer accounts at a single point of time and confirmation from customers for amounts outstanding in their accounts helps in identifying any leakage in collections.

(v) **Fraudulent Disbursements:** Fraudulent disbursements or reimbursements take place either by issuing or submission of false bills, or personal expense bills being converted into official expenses bills. The other method that is resorted to by the perpetrator of fraud is to inflate the refunds due to a customer and skim the excess refunds.

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(vi) **Expense Reimbursement Schemes:** These fraudulent schemes involve employees resorting to treating their personal expenses as incurred for business purpose and claiming reimbursement. In some cases, employees may get reimbursed by third parties (such as distributors) as well as by claiming these expenses from the company. Multiple expense claims based on duplicate bills or photostat copies.

(vii) **Payroll Fraud:** The payroll fraud could include payment to non-existent employees or in a contractual arrangement inflating of the manpower resources than those actually deployed while billing the client. It may also include showing higher pay than actual disbursement to employees/ workers, etc. The process would require a detailed review of statutory declarations/filings under various labour law statutes including disclosures in financial statements of retirement benefits such as P.F, Gratuity and Superannuation benefits from an evidence gathering perspective.

(viii) **Commission Schemes:** The salesman exaggerates the sales through fictitious billings to earn higher commission or alter the sales prices of the products sold from those stipulated by the company or share the sales volumes achieved with other employees to share higher commission. Commission schemes in mega deals backed by legal documents are often tools used to camouflage kickbacks. These are often difficult to uncover and would need to be supplemented by the monetary trails across entities and geographies.

Procedure for Investigation of Fraud: Before proceeding to investigate frauds of the type afore mentioned, the investigating accountant should ascertain the exact duties of the person concerned who is suspected to have committed a fraud; his relationship to the general routine of the office, and the circumstances in which any known instances of defalcation have come to light. Such an enquiry would give a clue to promising avenues of investigation. Greater the authority of the individual suspected of a fraud, wider would be the field which would have to be covered by the investigation. At times, an accountant is called upon to investigate a suspected fraud, the details or the nature whereof is not known. In such a case, for localising the source of the fraud, the investigating accountant will have to study the financial and accounting structure of the organisation. As a first step, he should examine the line of responsibility between the various members of the staff. He should have a look at the system of internal control in operation for spotting out the weaknesses, if any, that may exist in it. Relying on the above study, he should direct his enquiry towards those aspects of the business where there has been excessive control in the hands of single

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persons/ employee, without any supervision by any other person/ employee or, any other inherent weakness that may be in existence in the system.

Some of the situations in which money may be embezzled and the various forms that such frauds usually take place alongwith their investigation procedure include the following:

(a) **Cash receipts -** In cases like holding back cash sales, collections by travelling salesmen, V.P.P receipts, or casual receipts, e.g., sales of scrap, recoveries out of debts written off earlier, etc., the amount or amounts of receipts embezzled may be subsequently covered up by the perpetrator adopting one or other of the under-mentioned devices:

(i) Issuing a receipt to the payee for the full amount collected and entering only a part of the amount on the counterfoil.

(ii) Showing a larger cash discount than actually allowed.

(iii) Adjusting a fictitious credit in the account of a customer for the value of goods returned by him.

(iv) Adjusting a cash sale as a credit sale, and raising a debit in the account of the customer.

(v) Writing off a good debt as bad and irrecoverable to cover up the amount collected which has been misappropriated.

(vi) Short-debiting the customer's account in the ledger with an intention to withdraw the difference when the full amount payable by him is collected.

(vii) Under-casting the receipts side of the Cash Book or over-casting the payment side.

(viii) Carrying over a shorter total of the receipts from one page of the Cash Book to the next or over-carrying the total of the payment from one page of the Cash Book to the next with a view to covering up misappropriation; either short banking of cash collection or a part of the amount of withdrawal from the bank.

Verification of Cash Receipts: On the assumption that some of these may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised, e.g., inventory, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts. Carbon copies of receipts marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier. In addition, by recalling paying-in-slips from the bank the details of cash deposited on each day should be compared with those shown in the Cash

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Book. The record of sales of scrap of waste paper, that of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts deposited with the electric supply co., or any other Government authorities should be examined for finding out if any of these amounts have been misappropriated. Cash sales should be vouched in detail. Recoveries from customers and sundry parties should be checked with the copies of receipts issued to them; deductions made on account of cash discounts should be reviewed. All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.

(b) Inflating cash payment – Cash payment frauds may be in the form of:

(i) Making double payment of an invoice or paying a false invoice.

(ii) Paying personal expenses out of the business by falsifying details. e.g., showing betting losses as advertisement charges.

(iii) Withdrawing unclaimed credit balances of customers or amounts falsely credited in the accounts of parties.

(iv) Falsely adjusting a refund in the account of a customer and withdrawing the credit balance.

(v) Wrong totalling of the wage sheets and misappropriating the excess amount withdrawn from the bank for payment of wages.

Verification of Cash Payments: All the evidence as regards cash payments made, including acknowledgement by parties for payments shown to have been made to them, should be carefully scrutinised. In the case where a figure appears to have been erased or altered on the receipts issued by the party, on reference to the party concerned, the actual amount paid to him should be confirmed. The same procedure should be adopted in respect of amounts acknowledged on blank papers. All payments by bearer cheques should be examined. The system of recording of wages should be reviewed, specially as regards possible over-totalling of wage sheets, and entries in them of dummy workmen. The system of ordering and receiving goods should be reviewed so as to confirm that no payment has been made in respect of supplies which have not been received. Confirmations should be obtained from partners or Directors in respect of amounts shown to have been paid to them.

The Petty Cash Book should be vouched and totaled. Special attention should be paid to payments made on account of salaries and wages; confirmation should be obtained from the management that all payments of such salaries and wages were made to persons who were

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actually in the service of the company. All the withdrawals from the bank should be checked by reference to entries in the bank's pass book. All the bills receivable or payable should be checked by reference to the Bills Books.

(c) Frauds through suppliers' ledger -

(i) Adjusting fictitious or duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the amounts when payments are made to the suppliers in respect of these invoices.

(ii) Suppressing the Credit Notes issued by suppliers and withdrawing the corresponding amounts not claimed by them.

(iii) Withdrawing amounts unclaimed by suppliers, for one reason or another by showing that the same have been paid to them.

(iv) Accepting purchase invoices at prices considerably higher than their market prices and collecting the excess amount, paid in cash, from the suppliers.

Verification of balances in suppliers' ledger - The Purchase Journal should be vouched by reference to entries in the Goods Inward Book and the suppliers' invoices to confirm that amounts credited to the accounts of suppliers were in respect of goods, which were duly received and the suppliers' accounts had been credited correctly. All the suppliers should be requested to furnish statements of their accounts to see whether or not any balance is outstanding or due so as to confirm that allowances and rebates given by them have been correctly adjusted and were duly authorized by the authorized person/ officer. Examine the system of internal control in relation to purchase orders issued and identify possibilities of collusion with suppliers.

(d) Customers' ledger -

(i) By the 'teeming and lading' method, i.e., misappropriating the amount collected from a customer and crediting his account by the amount paid by him only when an amount is subsequently collected from another customer; repeating this practice with several items collected and depositing back the amount or amounts so misappropriated before the close of the year.

(ii) Misappropriating the amount collected from a customer and subsequently adjusting his account by crediting the amount on account of allowance or a rebate for excess price charged.

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(iii) Crediting the amount received from a customer to the account of another customer and subsequently withdrawing the amount wrongly credited.

Verification of balances in customers' ledger: Special attention should be paid to allowances adjusted on account of goods returned or difference in price or on any other account as well as to amounts written off as bad debts. To confirm that the accounts of customers have been debited in respect of goods supplied to them, entries in the Order Book should be cross-checked with those in the Sales Day Book where the same is kept. The investigating accountant should obtain confirmation of customers in respect of the amounts standing in their accounts. Those of them who have no balance in their accounts should be requested to confirm the statement of their account (which should be sent to them) for ascertaining that the entries shown therein were genuine.

(e) **Inventory Frauds-**Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

(i) Employees may simply remove goods from the premises.

(ii) Theft of goods may be concealed by writing them off as damaged goods, etc.

(iii) Inventory records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of inventories in hand.

(iv) Inflating the quantities issued for production is another way of defalcating raw materials and store items.

(v) Stocks actually dispatched but not entered in sales/ debtor's account.

Verification Procedure for Defalcation of inventory - It may be of trading stock, raw materials, manufacturing stores, tools or of other similar items (readily) capable of conversion into cash. The loss may be the result of a theft by an employee once or repeatedly over a long period, when the same have not been detected. Such thefts usually are possible through collusion among a number of persons. Therefore, for their detection, the entire system of receipts, storage and dispatch of all goods, etc. should be reviewed to localise the weakness in the system.

The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of: (a) a system of inventory control, and existence of detailed record of the movement of inventory, or (b) availability of sufficient data from which such a record can be constructed. The first step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the

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quantities in inventory held and those shown by the Inventory Book. Investigating accountant should ascertain the exact duties of persons handling the stocks received in and issued from store for production/ sale or any other purpose. Identify the excessive control in the hands of a single person, without any supervision as it will widen the scope of investigation.

Afterwards, all the receipts and issues of inventory recorded in the Inventory Book should be verified by reference to entries in the Goods Inward and Outward Registers and the documentary evidence as regards purchases and sales. This would reveal the particulars of inventory not received but paid for as well as that issued but not charged to customers. Further, entries in respect of returns, both inward and outward, recorded in the financial books should be checked with corresponding entries in the Inventory Book. Also, the totals of the Inventory Book should be checked. Finally, the shortages observed on physical verification of inventory should be reconciled with the discrepancies observed on checking the books in the manner mentioned above. In the case of an industrial concern, issue of raw materials, stores and tools to the factory and receipts of manufactured goods in the godown also should be verified with relative source documents.

Defalcations of inventory, sometimes, also are committed by the management, by diverting a part of production and the consequent shortages in production being adjusted by inflating the wastage in production; similar defalcations of inventories and stores are covered up by inflating quantities issued for production. For detecting such shortages, the investigating accountant should take assistance of an engineer. For that he will be more conversant with factors which are responsible for shortage in production and thus will be able to correctly determine the extent to which the shortage in production has been inflated. In this regard, guidance can also be taken from past records showing the extent of wastage in production in the past. Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent. The per hour capacity of the machine and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.

11.4.2 Indicators of Fraud

Several indications of possible frauds can be listed as follows :-

i.	Discrepancies in Accounting Records including non-recording or partial recording or incorrect recording or delayed recording of amounts, misclassifications, etc.
ii.	Conflicting or missing evidence including missing documents, altered documents, significant unexplained items in reconciliations, discrepancies between entity's records and confirmations received etc.

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iii.	Unacceptable management responses such as – denial of access to records/facilities/employees, undue time pressure to resolve complex issues, unusual delays in providing requested information, denial for use of Computer Assisted Audit Techniques, unwillingness to address identified deficiencies in internal control etc.
iv.	Other indications such as – Accounting Policies in variance with Industry Norms, Frequent changes in accounting estimates etc.

The Fraud Diamond: Considering the Four Elements of Fraud: Many frauds, especially some of the multibillion-dollar ones, would not have occurred without the right person with the right capabilities in place. Opportunity opens the doorway to fraud, and incentive and rationalization can draw the person toward it. But the person must have the capability to recognize the open doorway as an opportunity and to take advantage of it by walking through, not just once, but time and time again. This give rise to the fourth element of fraud.

Fraud Diamond i.e. four elements of fraud is a theory which was established by David T. Wolfe and Dana R. Hermanson. Under this Wolfe and Hermanson classified the indicators of fraud into 4 categories

Fraud Diamond: Four Elements of Fraud
• **Incentive:** I want to, or have a need to, commit fraud.
• **Opportunity** : There is a weakness in the system that the right person could exploit. Fraud is possible.
• **Rationalization:** I have convinced myself that this fraudulent behavior is worth the risks.
• **Capability:** I have the necessary traits and abilities to be the right person to pull it off. I have recognized this particular fraud opportunity and can turn it into reality.

A pictorial depiction of the Fraud Diamond is as follows:



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11.4.3 Responses to Fraud

SA 330 states the auditor's responses to assessed risks. It requires auditor to assign and supervise personnel taking into account of the knowledge, skill and ability of the individuals, evaluation of selection and application of accounting policies by the entity and incorporation of an element of unpredictability in the selection of the nature, timing and extent of audit procedure.

Response to the risks related to management override of controls includes Testing the appropriateness of journal entries and other adjustments made in preparation of the Financial Statements, review of accounting estimates for biases and also review the significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

Auditor need to assessed fraud risk factors for material misstatement or misappropriation of assets due to fraud, such as incentive / pressures, opportunities and attitudes /rationalizations.

The responses to fraud will include communications to management and with those charged with governance, communication to regulatory and enforcement authorities and appropriate documentation on his assessment of the risks of material misstatement.

Auditor's ability to detect fraud depends on factors such as –
— the skillfulness of the perpetrator
— the frequency & extent of manipulation
— the degree of collusion involved
— the relative size of Individual amounts manipulated; and
— the seniority of those individuals involved.

Detection of Fraud depends upon effectiveness of Audit Procedure. Detection risk, however, can only be reduced, not eliminated.

TEST YOUR UNDERSTANDING 2

A company has installed an Effluent treatment plant (ETP) in compliance with pollution control regulations of the state government. The authority structure in the company is fairly decentralized and top management of the company has given considerable leeway to different departments for meeting their manpower requirements in accordance with emerging and changing needs from time to time. Recently, the top management became concerned about the growing manpower expenditure in section maintaining and beautifying area around ETP. There is a system in the company where timecards are punched by all employees to mark attendance.

Suggest any one procedure you would perform as an investigator to bring out the facts.

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11.5 Investigation on behalf of an Individual or Firm Proposing to Buy a Business

Scope of investigation - The objective of such an investigation is to collect such information as would enable the purchaser to decide whether it is worthwhile to buy the business and if so, for what amount. The investigation should proceed broadly on the same lines as for valuation of shares.

Additional matters which must receive the attention of the investigating accountant on which, if appropriate, information to the client should be given.

(A) In case of proprietary concerns or partnerships -

(i) Reasons for the sale of the business and the effect on turnover and profits that there would be on retirement of the present proprietor (or partners).

(ii) The length of lease under which the premises are held, the prospects of its renewal or extension.

(iii) The unexpired period of any patents owned by the vendors.

(iv) The age of the present managerial staff and the prospects of continuing in service under the new proprietorship and the possible liability, not already provided for that would arise as regards payment of pensions or gratuities in case of old and aged employees/ retrenched employees.

(v) If the bulk of sales are made to customers whose number is small, the profitability of the business would be greatly shaken on withdrawing their support. This would be an element of weakness which should be investigated as it might affect future profitability.

(vi) The valuation that could be placed on goodwill to determine whether that appearing in the book is less or more; if none is included to determine the amount that should be included, if at all.

(B) If the business belongs to a limited company -The vendors' interest in this case will be purchased by the acquisition of shares. On that account, the following additional matters would also require consideration:

(i) The authorised and issued capital of the company.

(ii) Whether there is any uncalled liability on the shares.

(iii) If the capital is divided into different classes of shares - the rights that are attached to each class.

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(iv) Particulars of dividends paid in the past and the amounts thereof which are in arrear (on cumulative preference shares).

(v) If there are any mortgages/ charge created on the assets appearing in the company's books, a search should be made in the Register of Charges in the office of the Registrar of Companies.

(vi) The price at which the shares are being offered. If the company is a public company, the price will usually be in excess of market price quoted on the Stock Exchange, but in the case of unquoted shares particularly where the company whose shares are being acquired is a private company, a valuation will have to be placed on the shares for the purpose of purchase.

11.6 Investigation in connection with review of Profit/Financial Forecasts

There are many investigations which involve an examination of future profits like,

(1) Profit reports can be required as part of a general investigation into the purchase of a business or,

(2) By banks and financial institutions with regard to project cash flow and profitability statements for appraisal of loan applications submitted by the intending borrowers.

All forecasts depend, to a large extent, on the nature of the business with its numerous and substantial uncertainties. Therefore, such forecasts are not capable of verification by the reporting accountants in the same way as financial statements which present the results of a completed accounting period. Normally, such situations involve special review as these depart from the auditor's traditional role of expressing an opinion in relation to past events.

12. FORENSIC ACCOUNTING

The number of fraudulent activities and ambiguous financial activities have been accelerating all over the world. Consequently, businesses are exposed to risks of fraudulent activities. With all of the recent corporate accounting scandals at Parmalat, Xerox Corporation, and Satyam Computer Services, and all the high-profile corporate frauds at Enron, WorldCom, and HealthSouth followed by Bernie Madoff's colossal ponzi scheme, the media has made Forensic Accounting and Forensic Accounting into a growth industry.

Forensic Accounting has established itself as dynamic and strategic tool in combating corruption, financial crimes and frauds through investigations and resolving allegations of fraud and

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embezzlement. Thus, a new area, known as Forensic Accounting, was needed to detect the frauds in companies that suspected fraudulent transactions.

"Forensic" means "suitable for use in the court of law". Bologna said that it is the application of financial skills and investigative mentality to unresolved issues, conducted within the context of the rules of evidence. As an emerging discipline, it encompasses financial expertise, fraud knowledge and a sound knowledge and understanding of business reality and the working of legal system.

However, the definition of Forensic Accounting keeps on changing in response to the growing needs of corporations. Simply stated, Forensic Accounting includes the use of accounting, accounting and investigative skills to assist in legal matters.

Important Definitions:

Forensic: The word forensic comes from the Latin word forensis, meaning "of or before the forum." It is -

- Relating to, used in, or appropriate for courts of law or for public discussion or argumentation.
- Relating to the use of science or technology in the investigation and establishment of facts or evidence in a court of law.

Forensic Accounting: The integration of accounting, auditing and investigative skills yields the specialty known as Forensic Accounting. It is the study and interpretation of accounting evidence. It is the application of accounting methods to the tracking and collection of forensic evidence, usually for investigation and prosecution of criminal acts such as embezzlement or fraud.

Book definition: ***Forensic Accounting*** **by Hopwood, Leiner, and Young**

- Forensic accounting is the application of investigative and analytical skills for the purpose of resolving financial issues in a manner that meets standards required by courts of law.
- Forensic accountants apply special skills in accounting, auditing, finance, quantitative methods, certain areas of the law, research and investigative skills to collect, analyse and evaluate evidential matter and to interpret and communicate findings.

Red Flag: Red flags are indicators or warning of any impending danger or inappropriate behavior. Red flag does not necessarily indicate the existence of fraud however are indicators that caution needs to be exercised while investigating the situations. Red flags are classified in categories such as financial performance red flag, accounting system red flags, operational red flags and behavioral red flags.

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Forensic Accounting can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims. In addition, an audit may be conducted to determine negligence in addition, an audit may be conducted to determine negligence.

Example of Forensics

The Company received an anonymous handwritten letter through the mail containing serious death threats against the CEO and his family. The letter indicated to the fact that bodily harm may be inflicted on the Children of the CEO unless he took some specific action to send a specific amount of cash in currency notes within a specified time period in such a manner where the identity of the receiver was to remain unknown. The CEO immediately informed the police regarding who took the letter, and the envelope it came in, for “forensic analysis".

The lab undertaking the forensic work examined the paper used, the possibility of capturing some fingerprints on the letter and envelope, scrutinise the manner in which the writing was done, such as the ink used to find out the nature of the writing implement, deployed the expertise of a handwriting expert to decipher the possibility of the writer etc. The police also undertook an investigation of the possible suspects and collected various samples of handwritings of their suspects to allow the forensic experts to match the handwritings and shortlist the most likely suspect.

All the above-mentioned techniques deployed to analyse the only clue available (letter and envelope) are generally referred to as forensic work.

Example of Forensic Accounting

The Accounting Officer in the pharma company performs a regular reconciliation between the physical inventory counted in the factory and the inventory as calculated by the books and accounts. He takes the opening physical inventory as reconciled last month and adjusting for purchases and sales during the month along with any production wastage/shrinkage etc. he calculates the theoretical inventory at the close of the last day of the month. This time he noticed a large discrepancy and after double checking the figures could not understand why he had a large reconciliation variance.

To identify the reason for the variance, he undertook a review of the quantities of some of the large inventory items to see if he could identify the variance in kilogram weight terms. He noticed that some large expensive raw inventory items receipts during the month could neither be located in the storeroom or the factory production floor. He tried to trace these receipts to specific production runs to see if they had been used for making the medicines sold during the month. Finally, he reviewed the wastage records to see if these had been discarded due to quality control purposes. When he received no plausible explanation, he concluded that there is a serious possibility of pilferage of these expensive raw materials and asked the security head to investigate the matter during and after the time of receipt. This investigation led the security people to review the CCTV footage and records during delivery to identify a few instances of short delivery by the inward people.

This detailed analysis by the Accounting Officer was an example of some Forensic Accounting techniques to identify a case of accounting fraud.

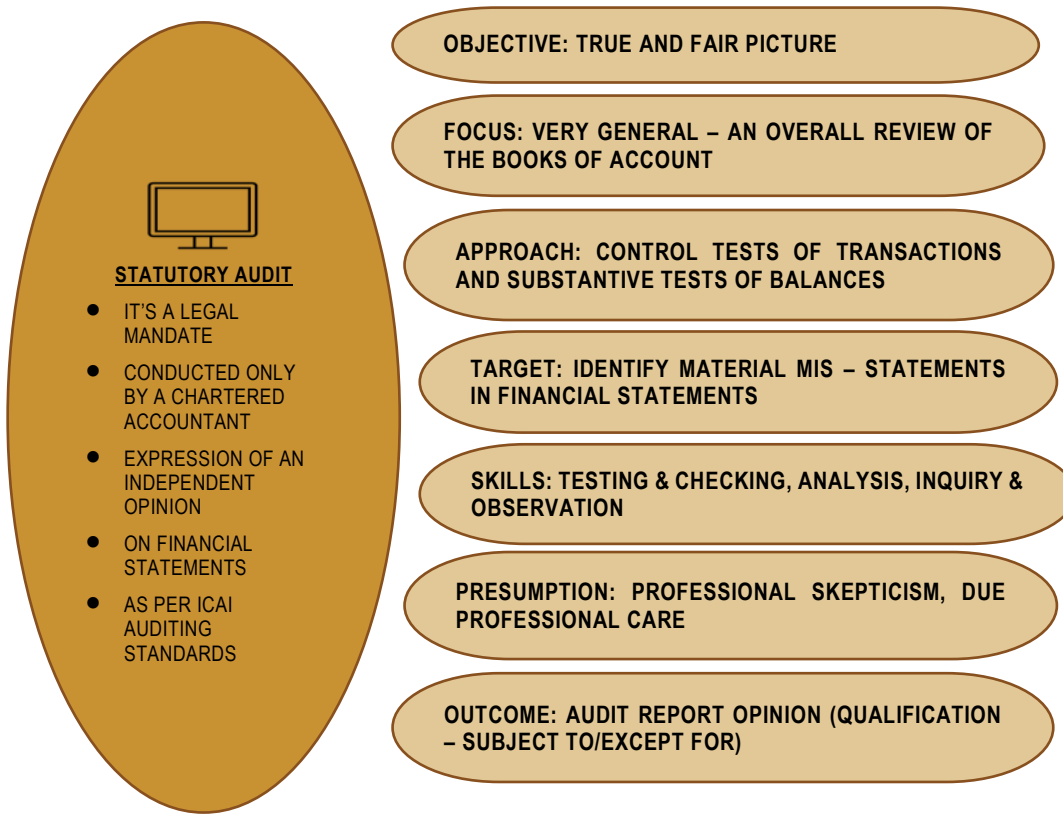
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How is a forensic accounting analysis different from an audit?

The general public believes that a financial auditor would detect a fraud if one were being perpetrated during the financial auditor's audit. The truth, however, is that the procedures for financial audits are designed to detect material misstatements, not immaterial frauds. While it is true that many of the financial statements and frauds could have, perhaps should have, been detected by financial auditors, the vast majority of frauds could not be detected with the use of financial audits. Reasons include the dependence of financial auditors on a sample and the auditors' reliance on examining the audit trail versus examining the events and activities behind the documents. The latter is simply resource prohibitive in terms of costs and time.

There are some basic differences today between the procedures of Forensic Accounting and those of financial auditors. In comparison, forensic accounting and audit differ in specific ways, as shown below:

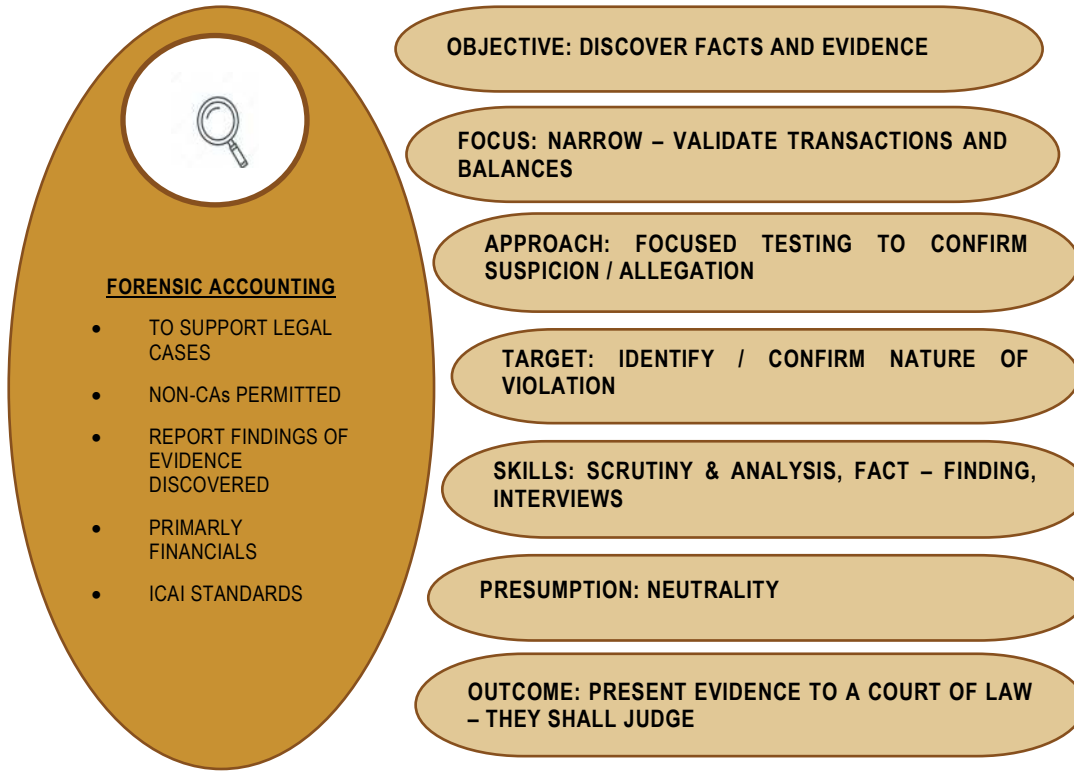
Key elements of the **Statutory Audit** are presented here:



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This shows clearly how the statutory audit is a legal mandate and designed to provide an overall assurance to the shareholders of the true and fair nature of the annual financial statements primarily from a materiality perspective. Individual transactions and balances do not play a major role except in so far as they have a material impact on the overall financial statements. The Auditor has the overall responsibility to issue his independent opinion without any influence from anyone.

Key elements of Forensic Accounting are presented here:



This infographic shows how Forensic Accounting is a separate mandate altogether and designed primarily to provide support to legal cases. The Forensic professional does not conduct an audit using sample selection methodologies to perform substantive or compliance tests. The professional undertakes a scrutiny and detailed examination of all transactions and balances relevant to the mandate so that the evidence discovered is suitable for a court of law (i.e., in compliance with legal requirements) where it can be challenged through cross examination by the defending party. No audit report with any opinion is issued by the professional as his mandate is limited to present his findings to a superior authority (e.g., a judge) who will examine these from a legal point of view to establish whether the law has been violated or not.

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Forensic Accounting

- *In response to an event
- *Financial investigation
- *Finding used as evidence in court or to resolve disputes

Audit

- *Mandatory
- *Measures compliance with reporting standards
- *Obtain reasonable assurance that financial statements are free of material misstatement

A Forensic Professional will often look for indications of fraud that are not subject to the scope of a financial statement audit. Forensic Accounting has **"Investigative mentality" however auditing is done with "professional scepticism". A Forensic Professional will often require more extensive corroboration. A Forensic Professional may focus more on seemingly immaterial transactions.**

Sr. No.	Particulars	Other Audits	Forensic Accounting
1.	Objectives	Express an opinion as to 'True & Fair' presentation	Whether fraud has actually taken place in books
2.	Techniques	Substantive & Compliance. Sample based	Investigative, substantive or in-depth checking
3.	Period	Normally for a particulars accounting period.	No such limitations
4.	Verification of stock, Estimation realisable value of assets, provisions, liability etc.	Relies on the management certificate/Management Representation	Independent/verification of suspected/selected items where misappropriation in suspected
5.	Off balance sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy & compliance with procedures.	Regulatory & propriety of these transactions/contracts are examined.
6.	Adverse findings if any	Negative opinion or qualified opinion expressed with/without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope.

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13. FORENSIC PROFESSIONAL

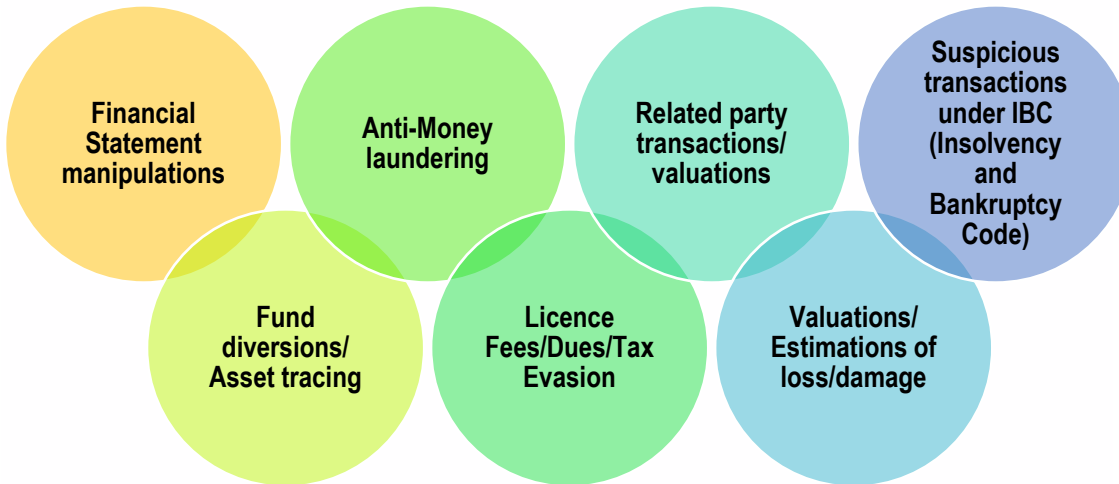
A Forensic Professional is often retained to analyze, interpret, summarize and present complex financial and business-related issues in a manner which is both understandable and properly supported. Forensic Professional are trained to look beyond the numbers and deal with the business reality of the situation.

A Forensic Professional must initially consider whether his/her firm has the necessary skills and experience to accept the work. Forensic Accounting is highly specialized, and the work requires detailed knowledge of fraud investigation techniques and the legal framework. Forensic Professional needs to have an understanding on various frauds that can be carried off and how evidence need to be collected.

Forensic Professional can be engaged in public practice or employed by insurance companies, banks, police forces, government agencies and other organizations.

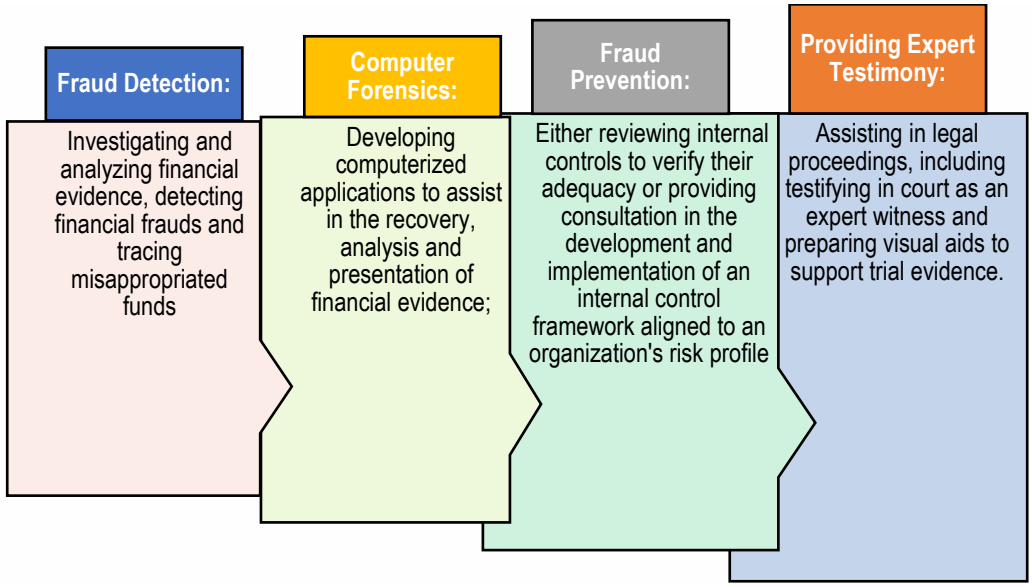
Forensic Accounting Services: An indicative list of services that can be provided by the Professional in this area are as follows:

- Financial Statement manipulations
- Fund diversions/Asset tracing
- Anti-Money laundering
- Licence Fees/Dues/Tax Evasion
- Related party transactions/valuations
- Valuations/Estimations of loss/damage
- Suspicious transactions under IBC (Insolvency and Bankruptcy Code)



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A Forensic Professional is often involved in:



In order to properly perform these services a Forensic Professional must be familiar with legal concepts and procedures and have expertise in the use of IT tools and techniques that facilitate data recovery and analysis. In addition, a Forensic Professional must be able to identify substance over form when dealing with an issue.

TEST YOUR UNDERSTANDING 3

X Limited engaged in manufacturing of floor coverings has taken a Product Liability Insurance policy (PLI). Such a policy covers risk of liabilities for damages for bodily injury resulting from sale and distribution of floor coverings by vendors of X Limited's products. The policy is also subject to "claim series" clause. A Claims Series event is a series of two or more claims arising from one specific common cause which are attributable to the same fault in design or manufacture of products or to the supply of the same products showing the same defect. A claim series event is deemed to be one claim under the terms & conditions of PLI policy.

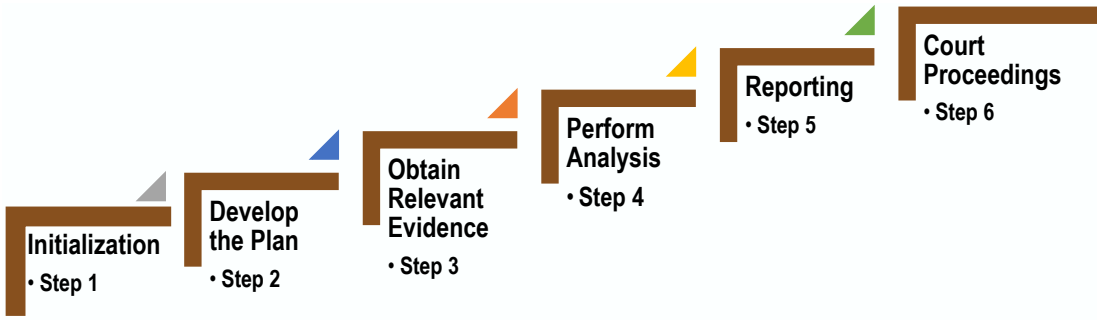
The company has been asked to shell out damages of ₹5 crore due to supply of faulty products to one of its vendors. The vendor had sold floor coverings to a 5-star hotel which has alleged that harmful chemicals used in dyeing of floor coverings have resulted in skin ailments to some of its guests.

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Being in capacity of Forensic Professional appointed by insurance company, what special issues you would keep in mind while dealing with claims involving PLI policy covering such matters?

14. PROCESS OF FORENSIC ACCOUNTING

Each Forensic Accounting assignment is unique. Accordingly, the actual approach adopted and the procedures performed will be specific to it. However, in general, many Forensic Accounting assignments will include the steps detailed below.



Step 1. Initialization

It is vital to clarify and remove all doubts as to the real motive, purpose and utility of the assignment. It is helpful to meet the client to obtain an understanding of the important facts, players and issues at hand. A conflict check should be carried out as soon as the relevant parties are established. It is often useful to carry out a preliminary investigation prior to the development of a detailed plan of action. This will allow subsequent planning to be based upon a more complete understanding of the issues.

Step 2. Develop Plan

This plan will take into account the knowledge gained by meeting with the client and carrying out the initial investigation and will set out the objectives to be achieved and the methodology to be utilized to accomplish them.

Step 3. Obtain Relevant Evidence

Depending on the nature of the case, this may involve locating documents, economic information, assets, a person or company, another expert or proof of the occurrence of an event. In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately

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prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case within the stipulated time period, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

Step 4. Perform the analysis

The actual analysis performed will be dependent upon the nature of the assignment and may involve:

• calculating economic damages;
• summarizing a large number of transactions;
• performing a tracing of assets;
• performing present value calculations utilizing appropriate discount rates;
• performing a regression or sensitivity analysis;
• utilizing a computerized application such as a spread sheet, data base or computer model; and
• utilizing charts and graphics to explain the analysis.

Step 5. Reporting

Issuing an report is the final step of a forensic accounting. Accountant / Investigators will include information detailing the fraudulent activity, if any has been found. The client will expect a report containing the findings of the investigation, including a summary of evidence, a conclusion as to the amount of loss suffered as a result of the fraud and to identify those involved in fraud. The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and findings and/or opinions. The report will include schedules and graphics necessary to properly support and explain the findings.

The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the organization to prevent any similar frauds occurring in the future.

Step 6. Court proceedings

The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will need to be presented at court, and team members may be called to court

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to describe the evidence they have gathered and to explain how the suspect was identified.

15. FORENSIC ACCOUNTING AND INVESTIGATION REPORT

This Forensic Accounting and Investigation Standard (FAIS or "Standard") 510 deals with the responsibility of the Professional to issue a written report to the stakeholders at the conclusion of the assignment.

Reporting results of the work procedures completed and the findings from those procedures, is the concluding part of the assignment. Since one engagement may include multiple assignments, multiple reports may have to be issued; one for each assignment.

1. **Written Report:** The Professional shall issue a written report which conveys the results of the assignment clearly and accurately. The findings reported shall be based on evidence gathered which are reliable and relevant. Thus, the Professional shall issue a written report which is precise and unambiguous.

2. **Report addressee and distribution:** The report shall be addressed to the Primary Stakeholders and shared with other stakeholder(s) if required or otherwise permissible

3. **Format or Content of Report:** While no fixed form or content of the report is mandated by this Standard, the report shall include certain key elements to enable the recipient to understand the purpose of the assignment, the extent and scope of work performed by the Professional, any limitations, assumptions or disclaimers, the facts and evidence gathered and the conclusions drawn.

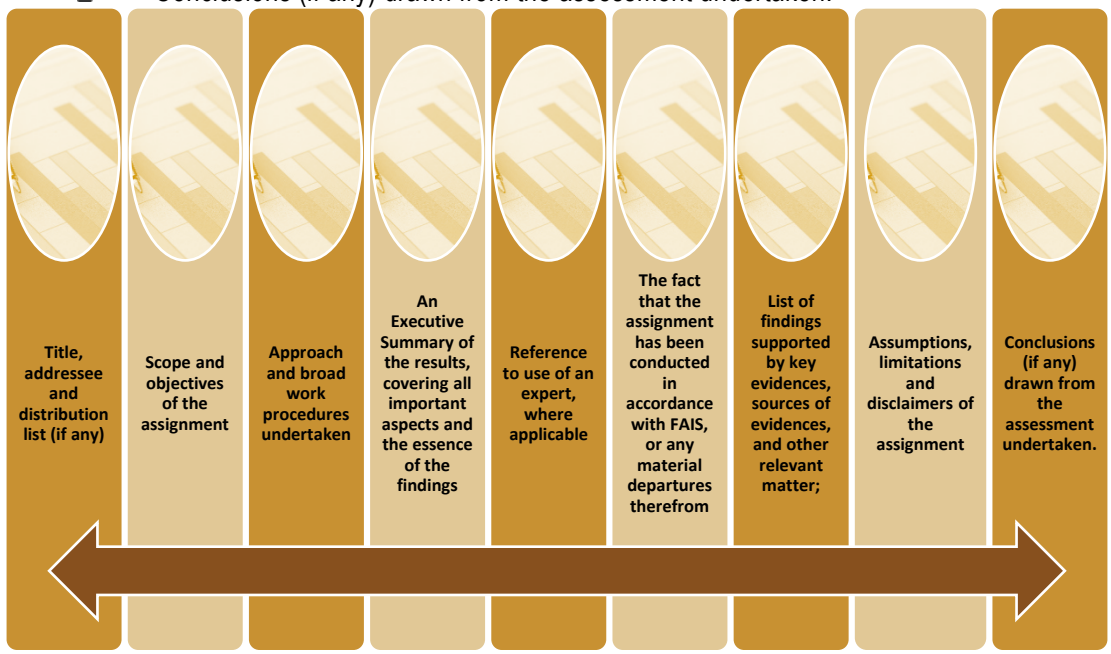
   Where the form and content of the report is mandated by the stakeholders, or specified by the statutory or regulatory requirements, the Professional shall report in line with those requirements, while keeping in mind the key elements.

   Key Elements of the Report: The Professional shall consider the inclusion of the following key elements in the report (indicative list):

   - Title, addressee and distribution list (if any)
   - Scope and objectives of the assignment

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- Approach and broad work procedures undertaken
- An Executive Summary of the results, covering all important aspects and the essence of the findings
- Reference to use of an expert, where applicable
- The fact that the assignment has been conducted in accordance with FAIS, or any material departures therefrom
- List of findings supported by key evidences, sources of evidences, and other relevant matter;
- Assumptions, limitations and disclaimers of the assignment
- Conclusions (if any) drawn from the assessment undertaken.



4. **Discussion of Draft report:** Where the mandate of the engagement requires a discussion of the findings with the subject party prior to finalisation, a summary of the responses received from them shall be included in the report. Further, the Principles of Natural Justice requires a discussion of the observations with the subject party. In some cases, this is done by the Primary Stakeholders through their own internal processes (e.g., disciplinary committee, show-cause notice, etc.). At times, the Professional is requested to incorporate the discussion of draft findings as part of the interview process with the subject. Where the engagement

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mandate requires a discussion of the draft findings with the subject party, any response received from them shall be included in the written report issued by the Professional.

5. **Assumptions and Limitations:** The Professional shall list any relevant assumptions made during the assignment having a significant bearing on the subject matter. In addition, the Professional may encounter limitations that restrict the methodologies or procedures applied in carrying out the assignment. Such limitations can be in the form of lack of (or limited) management support, restricted (or denied) access to required records, information or people, due to any reason such as court orders, short timelines, etc. These disclaimers would be covered in the report as a key element of the report.

   The report shall not express an opinion or pass any judgement on the guilt or innocence. Determination of culpability is either a disciplinary process internal to the organization under review, or a judicial process depending on the specific situation under review. The report can, at best, highlight the circumstances and facts that may aid a stakeholder decision or further a civil or criminal investigation.

6. **Reporting Timelines:** The report shall be issued within reasonable time frame as per the engagement terms. The Professional may be required to provide interim reports as per the engagement terms which can be given to the extent practicable without compromising the progress of the investigation. Such interim reports are also subject to this Standard.

16. OVERVIEW OF FORENSIC ACCOUNTING AND INVESTIGATION STANDARDS (FAIS)

The Institute of Chartered Accountants of India (ICAI) was formed with many mandates, one of which places a responsibility of "Ensuring Standards of Performance of its Members". In keeping with this obligation, the ICAI has recently published a full set of standards in the area of forensic science. These are referred to as the "Forensic Accounting and Investigation Standards (FAIS for short). The FAIS are issued to ensure that the ICAI members deliver high quality output in the area of Forensic Accounting and Investigations.

The Framework Governing Forensic Accounting and Investigations (the "Framework") lays down the underlying principles and boundaries for undertaking such services. It aims to preserve and enhance the quality of practice of a member of the Institute of Chartered Accountants (ICAI) performing forensic accounting and investigation services. This Framework needs to be read in conjunction with the Preface to the Forensic Accounting and Investigation Standards (FAIS).

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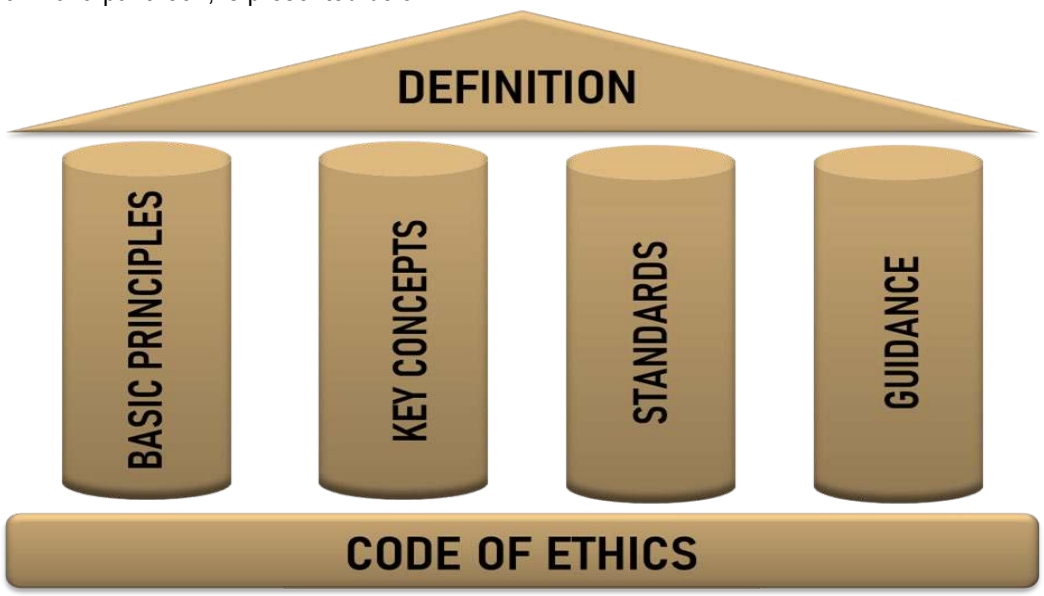
The main objectives of the Framework are to: 1 Provide an overall understanding of Forensic Accounting and Investigations and its key components; 2 Outline the manner in which these components come together in an inter-related cohesive manner when providing such services; 3 Maintain and improve the quality of forensic accounting and investigation services.

The Framework establishes the structure which governs the professions of Forensic Accounting and Investigations. It is based on the "Definition of forensic accounting and investigation" (as covered under para 3, above), and the Code of Ethics forms the foundation of the Framework. It comprises of four components inherent to the process of forensic accounting and investigations. These components implicitly form part of the FAIS, even though they may not be mentioned explicitly in the particular Standards. Hence, as explained in the Preface, they all are mandatory in nature, except the Guidance which is recommendatory.

The four key components (forming the pillars) of the Framework are:

(i) Basic Principles of Forensic Accounting and Investigations.	(ii) Key Concepts.	(iii) Standards on Forensic Accounting and Investigations.	(iv) Guidance.

A pictorial depiction of the Framework Governing Forensic Accounting and Investigations, in the form of a pantheon, is presented below.



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The Forensic Accounting and Investigation Standards (referred to as "FAIS" or the "Standards") at a broad level seek to provide:

(a) The Professionals with the minimum standards for undertaking forensic accounting and investigation (FAI) assignments;

(b) The Users of FAI services with an indication of the quality of service that can be expected from such engagements;

(c) The Regulators and Governmental agencies with an appreciation of what can be expected from FAI services; and

(d) To everyone, guidance on matters of implementation and related practical issues.

The Standards are intended to be principle-based, rather than rule based, thereby providing ample room for professional judgment when applying such principles to unique situations and under specific circumstances. The unique nature of forensic assignments would necessitate that the application of forensic accounting and investigative skills, together with the use of digital forensic tools, may vary depending on the nature of specific engagements.

If, for any reason, a member is unable to comply with any of the requirements of the FAIS, or if there is a conflict between the Standards and other mandates, such as a statutory or regulatory requirement, the FAI report (or such similar communication) should draw attention to the material departures therefrom along with appropriate explanation.

The FAIS, as and when issued, will be classified, and numbered in a series format, as follows:

Forensic Accounting and Investigation Standards (FAIS)
100 Series:: Standards on Key Concepts
FAIS 110 : Nature of Engagement
FAIS 120 : Fraud Risk
FAIS 130 : Laws and Regulations
FAIS 140 : Applying Hypotheses
200 Series: Standards on Engagement Management
FAIS 210 : Engagement Objectives
FAIS 220 : Engagement Acceptance and Appointment
FAIS 230 : Using the Work of An Expert

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FAIS 240 : Engaging with Agencies
FAIS 250 : Communication with Stakeholders
300 Series: Standards on Executing Assignments
FAIS 310 : Planning the Assignment
FAIS 320 : Evidence and Documentation
FAIS 330 : Conducting Work Procedures
FAIS 340 : Conducting Interviews
FAIS 350 : Review and Supervision
FAIS 360 : Testifying Before a Competent Authority
400 Series: Standards on Specialised Areas
FAIS 410 : Applying Data Analysis
FAIS 420 : Evidence Gathering in Digital Domain
FAIS 430 : Loans Or Borrowings
500 Series: Standards on Reporting
FAIS 510 : Reporting Results
600 Series: Standards on Quality Control
FAIS 610 : Quality Control

Key Takeaways

- Due Diligence implies a general duty to exercise care in any transaction. It is a measure of prudence activity, or dedication, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance, not measured by any absolute standard but depends on the relative facts of the special case.
- Due Diligence may also require to be performed in cases of corporate restructuring, venture capital financing, lending, leveraged buyouts, public offerings, disinvestment, corporatisation, etc.
- Contents of a due diligence report vary with individual circumstances and the purpose of such exercise.

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- Investigation implies a systematic and in-depth examination or inquiry to establish a fact or to evaluate a specific situation. It is the systematic and critical examination of facts, records and documents for a specific purpose.
- Investigation differs substantially from an audit assignment. Audit aims at collection of sufficient appropriate audit evidence to enable the auditor to form a judgement and express an opinion on the financial statements or other data under examination. An investigation, on the other hand, requires special in-depth examination of the particular records or transaction with the objective of establishing a part or happening or assessing a particular situation. The scope of audit is broad based and general in nature whereas investigation is narrow and specific.
- Investigation by Chartered Accountants can be statutory or non-statutory. Non-statutory investigations could include investigation of frauds or investigations in case of proposals to buy a business etc.
- Forensic accounting is the use of professional accounting skills in matters involving the possibility of a fraud, in order to collect relevant evidence and facts which could help support an expert view for potential or actual civil or criminal litigation. It is also called forensic accounting.
- Forensic accounting is different from audit of financial statements. A Forensic Professional will often look for indications of fraud that are not subject to the scope of a financial statement audit. Forensic accounting has investigative mentality" however auditing is done with "professional skepticism". A Forensic Professional will often require more extensive corroboration and may focus more on seemingly immaterial transactions.
- Services of forensic professionals may be used by banks, insurance companies, government agencies, courts and even by business community.
- Forensic Accounting and Investigation Standards (FAIS) aim to preserve and enhance the quality of practice of a member of the Institute of Chartered Accountants (ICAI) performing forensic accounting and investigation services.

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TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Sri Rajan is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. Ceta Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business.*

   What procedures you would adopt before you could render any advice to Ceta Ltd.?

2. *An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India. It requests you to conduct a "Due Diligence" of this Indian Company and submit your Report. List out the contents of your Due Diligence Review Report that you will submit to your USA based Client.*

3. *KDK Bank Ltd., received an application from a pharmaceutical company for takeover of their outstanding term loans secured on its assets, availed from and outstanding with a nationalised bank. KDK Bank Ltd., requires you to make a due diligence audit in the areas of assets of pharmaceutical company especially with reference to valuation aspect of assets. State what may be your areas of analysis in order to ensure that the assets are not stated at overvalued amounts.*

4. *"Due diligence is different from audit" – Explain the difference between due diligence and audit.*

5. *PB Ltd. entered into a deal with SV Ltd. for buying its business of manufacturing wooden products/ goods. PB Ltd. has appointed your firm for conducting due diligence review and they want to know the cash generating abilities of SV Ltd. What points will you check in order to ensure that the manufacturing unit of SV Ltd. will be able to meet the cash requirements internally?*

6. *CA Sanjana is acting as Credit manager in branch of DFC Bank Limited. A company has approached the branch for a request to sanction credit facilities worth ₹10 crore for meeting usual business requirements. It is a prospective new client. She checks past history of the company, background of promoters & directors, shareholding pattern and nature of business.*

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Assessment of financial results of past years and future projections is also undertaken. She also carries out SWOT analysis of the company.

Besides, assessment of net worth of directors is also undertaken. Status of CIBIL score and position of name of promoters/directors in RBI defaulter list is also verified.

She also makes discreet inquiries from few clients of the branch engaged in similar line of activity regarding credit worthiness of company, its promoters and directors.

Based on above-

(a) Identify activity being performed by CA Sanjana and discuss its nature.

(b) Would your answer be different if this activity was to be performed by a person not qualified as a Chartered Accountant? Can a non-CA perform such activity? State reason.

(c) Name any three other areas where identified activity can be undertaken.

7. *A nationalised bank received an application from an export company seeking sanction of a term loan to expand the existing sea food processing plant. In this connection, the General Manager, who is in charge of Advances, approaches you to conduct a thorough investigation of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not.*

   List out the points you will cover in your investigation before submitting your report to the General Manager.

8. *What are the important steps involved while conducting Investigation on behalf of an Incoming Partner?*

9. *Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation.*

10. *In a Company, it is suspected that there has been embezzlement in cash receipts. As an investigator, what are the areas that you would verify?*

11. *J Ltd. is interested in acquiring S Ltd. The valuation of S Ltd. is dependent on future maintainable sales. As the person entrusted to value S Ltd., what factors would you consider in assessing the future maintainable turnover?*

12. *MF Ltd., engaged in the manufacturing of various products in its factory, is concerned with shortage in production and there arose suspicion of inventory fraud. You are appointed by*

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MF Ltd. To evaluate the options for verifying the process to reveal fraud and the corrective action to be taken. As an investigating accountant what will be your areas of verification and the procedure to be followed for verification of defalcation of inventory?

13. *In a Public Limited Company, it is suspected by the Management that there has been embezzlement in supplier's ledger. As an auditor of the Company, you have been asked to investigate the matter. What are the major areas that you would verify in this regard?*

14. *General objective of an audit is to find out whether the financial statements show true and fair view. On the other hand, investigation implies systematic, critical and special examination of the records of a business for a specific purpose.*

    In view of the above, you are required to brief out the difference between Audit and Investigation.

15. *Enumerate the steps to be undertaken in case of forensic accounting process.*

16. *Briefly discuss the key content of Forensic Accounting and Investigation Report.*

17. *ABC Ltd. is a listed company having turnover of ₹ 50 crores & plans expansion by installation of new machines at new building-having total additional project cost of ₹ 20 crore.*

Rupees (In crore)	***Purpose***
10.0	*- for Building*
8.5	*- for Machinery*
1.5	*- for Working Capital*
20 Crore	*Total*

Project gets implemented in 2022-23 and one of the accountants report to the Managing Director that some suspicious transactions are noticed in the purchase of building material. But the Management is confused as to whether they should get an audit or Forensic Accounting done for the same. Advise Management about the difference in forensic accounting and audit.

18. ***CA Rajpal is performing a forensic accounting engagement involving gathering of evidence in relation to suspected fraud of substantial amount in a company. He has been appointed under the terms of a contractual agreement with the company.***

    The company operates in an electronic environment. While performing engagement, his team has gathered evidence from electronic records in Enterprise Resource Planning system (ERP), messages in company's e-mail system and also from system

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logs and audit trails generated by company's computer systems. However, while doing so, the team has failed to take care of aspects such as keeping records of each person in team gathering relevant evidence, date and time of collection and storage of such evidence. What implications may it have on forensic accounting engagement as such?

19. *Mr. Rajat, while reviewing the anti-fraud controls for a construction company, found that the company has witnessed a few frauds in the past mainly in the nature of material theft from the sites and fake expense vouchers.*

    Mr. Rajat is evaluating options for verifying the process to reveal fraud and the corrective action to be taken in such cases. As an expert in fraud prevention, you have been asked to brief Mr. Rajat about the inventory fraud and verification procedure with respect to defalcation of inventory.

20. *Sid is a financial analyst working for a large corporation that is considering the acquisition of a mid-sized manufacturing company. The initial financial statements provided by the target company appear to be in order, showing profits and a solid asset base. However, his team is concerned about potential risks that may not be immediately visible in the financial documents provided.*

    Guide Sid on what specific aspects should be focused during due diligence to ensure that there are no hidden liabilities in this deal?

21. *Quality Ltd. is engaged in the business of manufacturing and distribution of various Ready to cook products like vegetables, Noodles etc. The government made certain changes in rules and regulations relating to this sector, consequently management decided to go for expansion. Management was looking for some financial investor who can fund some part of the proposed expansion. Mr. Aman is interested in the venture and appoints you to act as an advisor to the proposed investment in the business of Quality Ltd. You have to investigate the audited financial statements and ensure that the valuation of shares of the company on the basis of audited financial statements is appropriate. What process will be used for checking and can reliance be placed on the already audited statement of accounts?*

22. *Core Limited submitted a credit proposal XYZ Bank Limited for the sanction of a Term Loan of ₹ 150.00 crore required for procuring and installing a latest Plant and machinery for their upcoming project. Based on the application, XYZ Bank Limited approached CA P to investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by Core Limited, as well as the value*

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of the security in the form of assets of the business already possessed and those which will be created out of the loan. Elucidate the steps that should be undertaken by CA P?

Answers to Test Your Understanding

1. As a part of due diligence exercise, he is performing SWOT analysis of borrower. He is making analysis of strengths, weaknesses, opportunities and threats (SWOT) pertaining to borrower. Features such as rise in sales, generation of cash profits and timely service of debts represent borrower strengths. Lack of well-paid qualified staff to deal effectively with its domestic and foreign customers is an area of weakness. Entering into export market presents an opportunity for borrowers and the presence of large number of competitors and demand slump in the US market reflect threats.

2. The attendance record of employees pertaining to that section can be analysed with regards to in and out time. Further, surprise visit to the site can be conducted to see the actual number of workers at a point of time. It may reveal ghost workers. Discrepancies in attendance records vis-à-vis actual number of workers present could reveal dummy workers. Such a visit would also give indication of actual work done in the area and give an inkling of productivity of employees.

3. (i) In claims involving product liability insurance policies, many documents are required from third parties. The third party may be unwilling to provide relevant documents to Forensic Professional concerning the very organization responsible for causing damages.

(ii) Independence of Forensic Professional become paramount in such types of assignments because it involves engagement with parties who are not directly claiming from insurance company. Forensic Professional needs to resist any pressure or interference in establishing the scope of the assignments or the manner in which the work is conducted and reported.

(iii) The company might be willing to negotiate it to salvage its reputation. It can lead to additional complexities.

(iv) Quantification of legal liability under the policy can prove to be a challenging task and it has to be determined in accordance with policy terms & conditions.

(v) Careful analysis of date of loss when first claim occurred in accordance with "claim series" clause and whether the same falls under the policy

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Hints /Answers to Theoretical Questions

1. Refer Financial Due Diligence given in Para 3.

2. Refer Para 6.

3. Refer Over-Valued Assets Part given in Para 3.

4. Refer Para 1.

5. In order to ensure that the manufacturing unit of SV Ltd. will be able to meet the cash requirements internally, one is required to verify:

(a) Is the company able to honor its commitments to its trade payables, to the banks, to the government and other stakeholders?

(b) How well is the company able to convert its trade receivables and inventories?

(c) How well the Company deploys its funds?

(d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(e) What is the investment pattern of the company and are they easily realizable?

Refer Cash Flow in Para 3.

6. **(a)** The activity described in the situation is Due diligence. Due diligence is a measure of prudence activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance, not measured by any absolute standard but depending upon the relative facts of the case. It involves a careful study of financial and non-financial possibilities. It implies a general duty to take care in any transaction.

Due diligence is a process of investigation, performed by investors, into the details of a potential investment such as an examination of operations and management and the verification of material facts. It entails conducting inquiries for the purpose of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction. Due diligence involves a careful study of the financial as well as non-financial possibilities for successful implementation of restructuring plans.

Due diligence involves an analysis carried out before acquiring a controlling interest in a company to determine that the conditions of the business conform with what has

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been presented about the target business. Also, due diligence can apply to recommendation for an investment or advancing a loan/credit.

(b) There would be no difference in answer if above activity was to be performed by a person who is not a Chartered Accountant. The activity would remain due diligence. Due diligence can be performed by any person. It is not necessary that due diligence can only be carried out by a Chartered Accountant. As due diligence involves exercise of prudence and general duty to take care in any transaction, it can be undertaken by any person.

(c) The areas where due diligence may be undertaken are: -

(i) Corporate restructuring

(ii) Venture capital financing

(iii) Public offerings

7. Refer Para 11.3.

8. Refer Para 11.1.

9. Refer Para 10 and 11.5.

10. Refer Cash Receipts embezzlement in Para 11.4.1.

11. In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

(i) **Trend:** Whether in the past, sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.

(ii) **Marketability:** Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.

(iii) **Political and economic considerations:** Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

(iv) **Competition:** What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

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12. Refer Inventory Fraud in Para 11.4.1.

13. Refer Areas to be verified in case of embezzlement in supplier's ledger in Para 11.4.1.

14. Refer Para 7.1.

15. Refer Para 14.

16. Refer Para 15.

17. Refer Para 12.

18. ***In a forensic accounting engagement, professional undertakes a scrutiny and detailed examination of all transactions and balances relevant to the mandate so that evidence gathered is suitable in a Court of Law i.e. in compliance with legal requirements where it can be challenged through cross-examination by the defending party.***

It is important that team is skilled in collecting evidence that can be used in a court case keeping a clear chain of custody till evidence is presented in court. If there are gaps in chain of custody, then the evidence may be challenged in court or even become inadmissible.

In the given case, team has failed to keep record of matters such as persons gathering relevant evidence, date and time of collection and storage of evidence. Therefore, team has failed to maintain the chain of custody.

It can, therefore, defeat the objective of forensic accounting engagement as evidence may be challenged in Court of law by defending parties and may become inadmissible.

19. ***Refer Inventory Frauds Part given in Para 11.4.3.***

20. ***Refer hidden liabilities Part given in Para 3.***

21. ***In the instant case, Quality Ltd. is engaged in the business of manufacturing and distribution of various ready-to-cook products like vegetables, noodles etc. Further, management was looking for some financial investor to fund some part of the proposed expansion. Aman is interested in funding; therefore, he initiated investigation of audited financial statements to ensure the appropriateness of the valuation of the shares. For initiating the same it may be considered that if the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises. However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put***

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reliance on audited materials made available to him unless, in the course of his test verification, he finds the audit to have been carried on very casually or unless his terms of appointment clearly require to test everything afresh.

- *If the statements of account produced before the investigator were not audited by a qualified accountant, then of course there arises a natural duty to get the figures in the accounts properly checked and verified.*
- *However, when the accounts produced to the investigator have been specially prepared by a professional accountant, who knows or ought to have known that these were prepared for purposes of the investigation, he could accept them as correct relying on the principle of liability to third parties.*
- *It would be prudent to see first that such accounts were prepared with objectivity and that no bias has crept in to give advantage to the person on whose behalf these were prepared.*

22. Refer Para 11.3.

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CHAPTER 18

SUSTAINABLE DEVELOPMENT GOALS(SDG) & ENVIRONMENT, SOCIAL AND GOVERNANCE (ESG) ASSURANCE



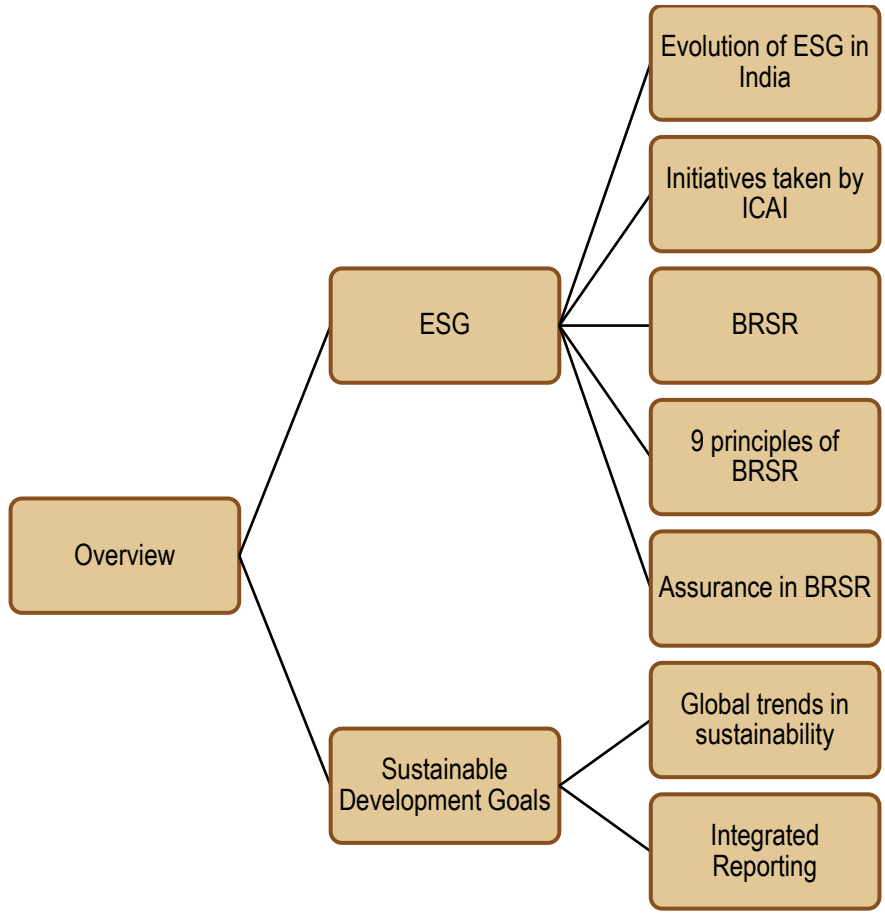
LEARNING OUTCOMES

After reading this chapter student shall be able to:

- Understand Environment, Social and Governance (ESG) pillars of sustainability.
- Learn the Sustainable Development Goals which have been accepted by all the United Nation Members.
- Create an awareness of the Global trends of Sustainability.
- Understand the evolution of ESG in India.
- Gain knowledge of ICAI's role in Sustainability.
- Learn about Integrated Reporting and how it can help our profession.
- Gain the knowledge of role of Auditor in Sustainability forum and certifying the BRSR.
- Analyze the Business Responsibility and Sustainable Reporting requirements.

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CHAPTER OVERVIEW



CA Ajoy was keen to understand about sustainability reporting by corporates in light of mandatory regulatory requirements. One of his corporate clients was required to do such reporting and assurance report was also needed. In this context, he wanted to familiarize himself with terms like Sustainable development and Sustainable Development Goals (SDGs) thoroughly.

Sustainable development simply means development that meets the needs of the present without compromising the ability of future generations to meet their own needs. SDGs are a universal call for action to end poverty, protect the planet and improve the lives and prospects for everyone- everywhere.

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Our country has always been in forefront of welfare of humanity. Our ancient texts say: *"Keep pure! For the earth is our mother! And we are her children!"* How can a country with such a universal vision can be left behind in this noble endeavour? And corporates also contribute to the SDGs. It is due to the fact that world is in need of solutions that the private sector can deliver representing a large market for innovation.

It is in line with this spirit that Sustainability reporting frameworks have evolved over time and companies worldwide have adopted these frameworks for measuring, monitoring and disclosing performance in areas related to environmental, social and governance (ESG). Many countries have stipulated some form of ESG disclosures.

ESG reporting stands on three pillars viz. *environmental, social and governance.* Certain listed companies have to disclose their sustainability performance in accordance with key performance indicators and 9 principles. Doesn't it sound interesting? These principles range from conducting business in ethical manner to promoting human rights.

As part of ESG reporting, it is mandatory for certain listed companies to prepare and disclose sustainability reports in shape of Business responsibility and sustainability reports (BRSR). Like in case of meeting requirements of the principle that business is conducted with integrity and in ethical manner, disclosures on anti-bribery policy like internal control mechanisms and mechanisms to deal with bribery/corruption complaints are to be made. Such disclosures are now mandatory for certain listed companies considering each of the 9 principles.

Isn't such a reporting framework a giant leap forward?

1. INTRODUCTION

Sustainability is a word that has gained its momentum in the past few years, but we do not often understand the extent of the meaning in totality. It encompasses how natural systems work, continue to be diverse, and yield everything required for the environment to remain in balance now and in the future.

Sustainability is a concept related to the development of products, goods and services that involves meeting our present needs without compromising the ability of future generations to fulfil their own needs.

Sustainability as a concept recognises that the environment is an exhaustible resource. Therefore, it is important to use the environment and its resources rationally and protect it for the good of the Earth, our environment, humanity, and all living things.

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The concept of sustainable development is named after the Brundtland report, which reports sustainable consumption in developed countries.

Sustainable Development defined in this report is as follows:

"*Sustainable development is development that strives to meet the needs of developing countries seeking to achieve a more sustainable world. Sustainable development addresses the needs of the present moment without compromising current and future generations to meet their own sustainable lifestyles.*"

Sustainable development can be applied to corporate policy in the business world as it encompasses following three pillars of sustainability:

A. Environment (E)

B. Social (S)

C. Governance (G)

These three pillars constitute the term ESG. Let us understand each element of ESG in depth.

A. Environment (E):

Environmental stands for corporate climate policies, energy use, waste, pollution, natural resource conservation, and treatment of animals. It includes the natural resources that every entity absorbs for its functioning like that of coal, electricity, water and so on. Processing this energy into products / services which will leave behind certain wastes like that of carbon emissions, water discharges, e-wastes and so on. Thus, one is dependent on the environment for carrying out its operations.

B. Social (S):

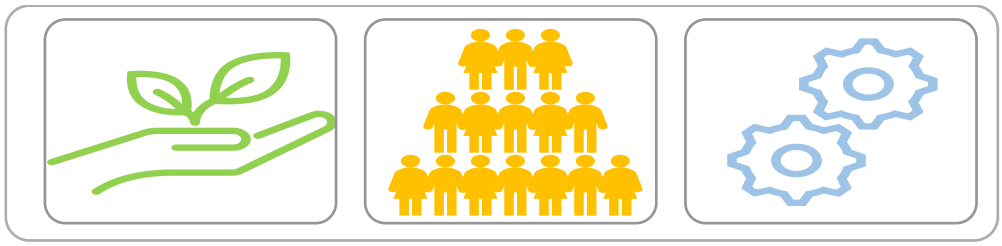
It addresses the relationships the entity has and the reputation it fosters with people and institutions in the communities where you do business, and the value chain involved. It further includes labour relations, diversity, and inclusions. Every company operates within a broader and diverse society.

C. Governance (G):

It is the internal system of practices, controls, and procedures entity adopts in order to govern itself, make effective investment decisions, comply with the law, and meet the needs of all stakeholders. Every entity, which is itself a legal creation, requires governance.

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The above pillars include the following elements as under:



ENVIRONMENT

- **Climate Change:**
  - Carbon Emissions
  - Product Carbon FootPrints
  - Financing Environmental Impact
  - Climate Change Vulnerability
- **Natural Resources:**
  - Water Stress
  - Bio-diversity & land use
  - Raw Material sourcing
- **Pollution & Waste:**
  - Toxic emission and waste
  - Packing Material and waste
  - E- Waste
- **Environment Opportunity:**
  - Clean Tech
  - Green Building
  - Renewable Energy

SOCIAL

- **Human Capital:**
  - Labour Management
  - Health & Safety
  - Human Capital Development
  - Supply Chain Labour Standards
- **Product Liability:**
  - Product Safety & Quality
  - Chemical Safety
  - Financial Product Safety
  - Privacy and Data Security
  - Responsible Investment
- **Stakeholders Opposition:**
  - Controversial Sourcing
- **Social Opportunity:**
  - Access to Communication
  - Access to Finance
  - Access to Health Care
  - Opportunities in Nutrition & Health

GOVERNANCE

- **Corporate Governance:**
  - Broad Diversity
  - Executive Pay
  - Ownership
  - Accounting
- **Corporate Behaviour**
  - Business Ethics
  - Anti - Competitve Practices
  - Corruption & Instability
  - Financial system and stability
  - Tax Transparency

Environmental, Social and Governance (ESG) reporting is all about disclosure of information, data, metrics that explain the added value in these three areas. ESG reporting can be both quantitative and qualitative in nature.

Qualitative reports tend to describe a company's strategy or policy around the relevant topics, while a quantitative approach includes metrics, and key performance indicators (KPIs) linked to each area in order to measure progress against goals and report on achievements. Naturally, a mixed approach that makes use of both qualitative and quantitative information tends to add the maximum value to the quality of disclosures.

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2. SUSTAINABLE DEVELOPMENT GOALS

In 2015, Sustainable Development was adopted by all United Nations Members states to provide a blueprint, which mentioned the Sustainable Development Goals (SDGs).

There were 17 SDGs which are considered as an urgent call for action by all countries, whether developed or developing countries. They recognized that by ending poverty and other deprivations must go hand in hand with strategies that improve health and education, reduce inequality, and spur economic growth – all while tackling climate change and working to preserve our oceans and forests.

Today, the Division for Sustainable Development Goals (DSDG) in the United Nations Department of Economic and Social Affairs (UNDESA) provides substantive support and capacity building for the SDGs and their related thematic issues including water, energy, climate, oceans, urbanization, transport, science and technology, the Global Sustainable Development Report (GSDR), partnerships and Small Island Developing States. SDG plays a key role in the evaluation of UN systemwide implementation of the 2030 Agenda and on advocacy and outreach activities relating to the SDGs. In order to make the 2030 Agenda a reality, broad ownership of the SDGs must translate into a strong commitment by all stakeholders to implement the global goals. DSDG aims to help facilitate this engagement.

Following are the 17 SDGs:



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3. GLOBAL TRENDS IN SUSTAINABLE REPORTING

The mandatory reporting requirements are mostly associated with the public sector or government-run companies, large corporations, multi-national business conglomerates, and listed companies in the stock exchanges. Furthermore, sector-specific, and thematic reporting provisions are also becoming more common.

The most widely used framework in the world is the Global Reporting Initiative (GRI) Sustainability Reporting Standards having 93% of the world's largest 250 corporations report on their sustainability performance through GRI. It is used in over 100 countries to report sustainability. This independent international organization is based in Amsterdam, the Netherlands, and has operational hubs in Brazil, China, Colombia, India, South Africa, and the United States. The GRI Sustainability Reporting Standards are developed with true multi-stakeholder contributions and rooted in the public interest.

1. **Global Reporting Initiative (GRI) –** helps the organizations to report on economic, environmental, and social impacts. The general disclosures which are required to be reported under this standard are Economic, Environment and Social. This report is addressed to all the stakeholders of the entity.

2. **Carbon Disclosure Project (CDP) –** captures the environmental performance data which is related to GHG emissions, water, forests, and supply chain. Major details required to be reported are climate change, Forest, and Water security. This report is addressed to all the investors, buyers, and other stakeholders of the entity.

3. **International Integrated Reporting Framework (IIRC) –** has established guiding principles and content elements in order to allow the companies to produce integrated reports. This report consists of Organisational overview, Governance structure, Business model, risks and opportunities, strategy, performance, outlook etc.

In September 2020, these framework & standard setting institutions came together to show a commitment to working towards a **comprehensive corporate reporting system.**

The intent of the collaboration was:

- Joint market guidance on how the frameworks & standards can be applied in a complementary and additive way.

- Joint vision of how these elements could complement financial generally accepted accounting principles (Financial GAAP) and serve as a natural starting point for progress towards a more coherent, comprehensive corporate reporting system.

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- Joint commitment to drive towards this goal, through an ongoing programme of deeper collaboration between the 5 institutions and stated willingness to engage closely with other interested stakeholders.

In November 2021, the IFRS Foundation Trustees published a revised *Constitution* and a Feedback Statement that responds to the feedback from Exposure Draft *Proposed Targeted Amendments to the IFRS Foundation Constitution to Accommodate an International Sustainability Standards Board to Set IFRS Sustainability Standards*.

International investors with global investment portfolios are increasingly calling for high quality, transparent, reliable, and comparable reporting by companies on climate and other environmental, social and governance (ESG) matters.

On 3 November 2021, the IFRS Foundation Trustees announced the creation of a new standard-setting board—***the International Sustainability Standards Board (ISSB)***—to help meet this demand.

The intention is for the ISSB to deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions.

Task Force on Climate-Related Financial Disclosures (TCFD) - It was created in 2015 by the Financial Stability Board (FSB) with the goal of helping companies create consistent climate-related disclosures. Unlike GRI, which works on a wide range of organizations, TCFD is targeted at companies that predominantly handle financial-related interests, such as banks and insurance firms.

The Climate Disclosure Standards Board (CDSB) was an international group of business and committed to making climate-rated disclosures in mainstream global corporate reporting.

The CDSB framework was formed to help organizations to disclose climate related risks and opportunities. The CDSB framework has also set out an approach for reporting environmental information.

Further, the ISSB has taken the technical guidance for developing IFRS Sustainability Disclosure Standards.

The Value Reporting Foundation (VRF) is a non-profit organization which was a result of the merger between SASB Foundation and the International Integrated Reporting Council (IIRC). The International Accounting Standards Board (IASB) and the ISSB have agreed to work together in

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order to build an Integrated Reporting Framework.

The International Sustainability Standards Board (ISSB) in March 2022 launched a consultation on its first two proposed standards—one on climate-related disclosures and one on general sustainability-related disclosures. The proposed standards, when finalised, would form a comprehensive global baseline of sustainability-related disclosures designed to meet the information needs of investors in assessing enterprise value.

IFRS S1 : The proposed requirements in the Exposure Draft IFRS S2 Climate-related Disclosures (Climate Exposure Draft) build upon the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) and incorporate industry-based disclosure requirements derived from the Sustainability Accounting Standards Board (SASB) Standards.

TEST YOUR UNDERSTANDING 1

You have recently joined a listed company after qualifying CA final exams through campus placement programme conducted by CMI&B at ICAI. Although the company you have joined in is not amongst top 1000 listed companies in the country, it wants to include "Sustainability reporting" in accordance with Global Reporting Initiative framework (GRI) in its annual report on voluntary basis. "Sustainability reporting" seems to be new buzzword in corporate circles and you are assigned responsibility for collating all the information required for such reporting.

In the above context, dwell upon what is your understanding of "Sustainability reporting"? Can you list some of its expected benefits?

4. INTEGRATED REPORTING

There are 6 Cs of Integrated Reporting – also known as 6 capitals:

(i) Financial Capital:

- Pool of funds that is available to the organization for use in the production of goods or provision of services.
- Obtained through financing, such as debt, equity, or grants, or generated through operations or investments.

(ii) Manufactured Capital:

- Seen as human-created, production-oriented equipment and tools.

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- Available to the organization for use in the production of goods or the provision of services, including buildings, equipment, infrastructure (such as roads, ports, bridges & waste, and water treatment plants).

(iii) Natural Capital:

- Is an input to the production of goods or the provision of services.
- An organization's activities also impact, positively or negatively, on natural capital.
- Includes water, land, minerals and forests, biodiversity, and ecosystem health.

(iv) Human Capital:

People's skills and experience, their capacity, and motivations to innovate, including their:

- Alignment with and support of the organization's governance framework & ethical values such as its recognition of human rights.
- Ability to understand and implement an organization's strategy.
- Loyalties and motivations for improving processes, goods, and services, including their ability to lead and to collaborate.

(v) Social Capital:

- Institutions and relationships established within and between each community, group of stakeholders and other networks to enhance individual and collective well-being.
- Includes:
    - Common values and behaviour.
    - key relationships, the trust and loyalty that an organization has developed and strives to build and protect with customers, suppliers, and business partners.
    - an organization's social license to operate.

(vi) Intellectual Capital:

Key element in an organization's future earning potential, with a tight link and contingency between investment in R&D, innovation, human resources, and external relationships, which can determine the organization's competitive advantage.

Asia Pacific region continues to dominate in presenting sustainability data in annual reports. Approximately 60% of Companies reporting in 2022. Integrated reporting is strong in the Middle East.

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TEST YOUR UNDERSTANDING 2

Trustworthy Industries Limited (a listed company) has already been preparing and disclosing its sustainability report based upon internationally accepted reporting framework of "Integrated Reporting" on a voluntary basis even some years before BRSR reporting became mandatory. Even after BRSR reporting became mandatory, it is cross-referencing disclosures made under such reporting to disclosures sought under BRSR. The key thrust of "Integrated Reporting" is how company creates value over short, medium and long term.

Following further information is provided in respect of the above company: -

[i] It has increased the number of customers using digital customer mobile app of the company from 2 lac users to 4 lac users. There is 100% increase in digital collection. It has benefitted customers of the company and resulted in use of digital methods for business operations of the company.

[ii] It has increased the number of beneficiaries under its flagship CSR programmes from previous 10000 to 75000. It has provided value for communities and provided sustainable livelihood to them.

Discussing above information, identify which of the capitals of "Integrated Reporting" are being referred to at [i] and [ii] respectively?

5. GLOBAL SCENARIO IN VARIOUS COUNTRIES

5.1 United States

In March 2022, the US Securities and Exchange Commission (SEC) proposed climate-risk disclosure requirements, which would expand the annual reporting requirements of publicly traded companies. In their SEC filings, companies would be required to discuss financially material, climate-related risks guided by the TCFD recommendations. Reporting would include:

- The company's climate risk management processes
- How the risks identified would impact financial performance
- How these risks are managed and mitigated
- Any scenario analysis, transition plans, and publicly announced climate goals

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5.2 United Kingdom

In 2019, the UK passed a law targeting net zero greenhouse gas (GHG) emissions by 2050.

A key regulation for UK ESG disclosures is the Companies Act of 2006, which includes requirements for annual reporting. These rules apply to large companies that are either listed, exceed £500 million in annual turnover, or have more than 500 employees. Non-financial information has always been required in annual reports, but in 2022, the Act was expanded to include sustainability matters. The new requirements align with the recommendations from the Task Force on Climate-Related Financial Disclosure (TCFD). As such, companies are required to discuss the strategy, processes, and due diligence regarding matters of:

-	The environment (including the company's impact on the environment)
-	The company's employees
-	Social matters
-	Respect for human rights
-	Anti-corruption and anti-bribery

Specifically for the environment, climate-related disclosures must include:

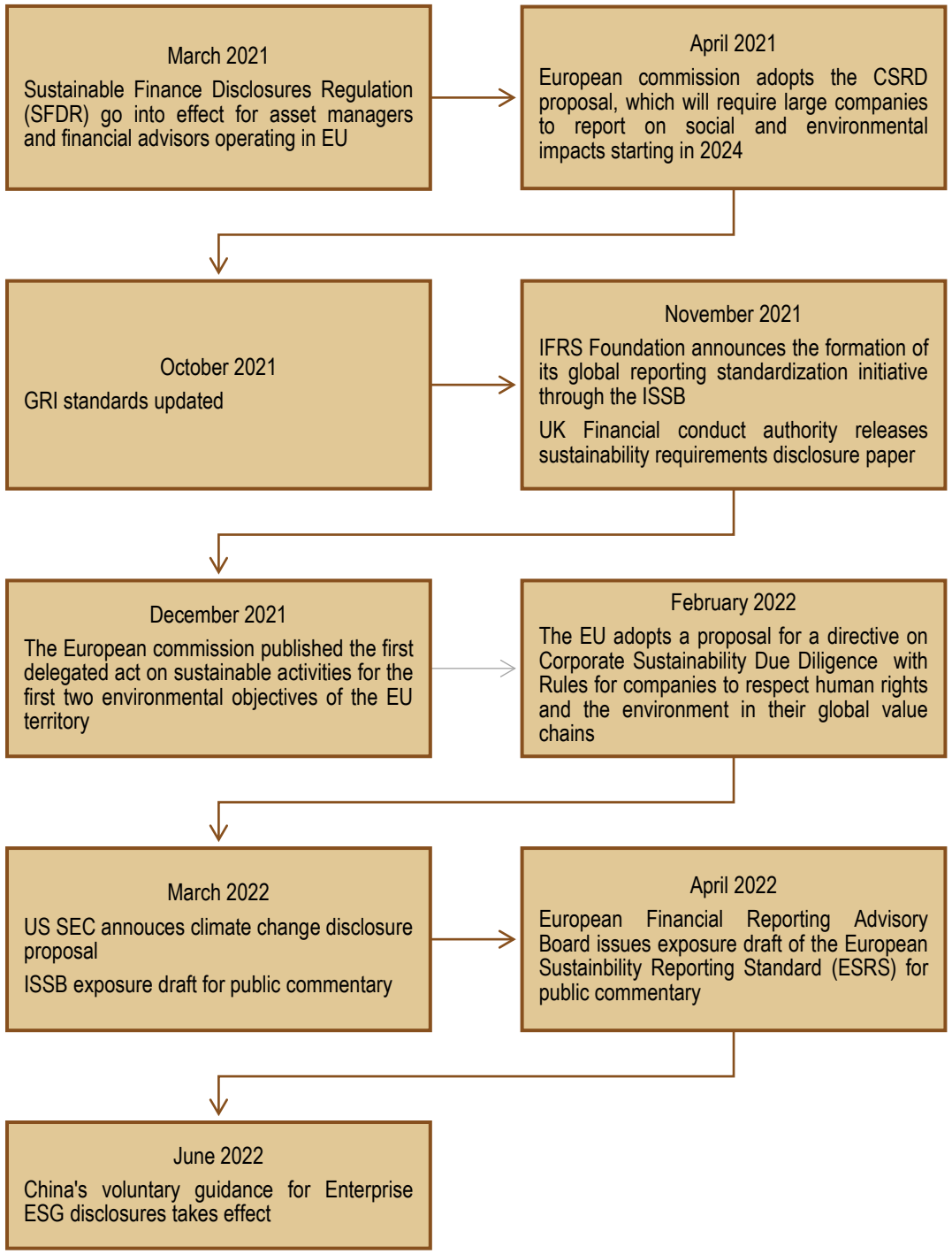
- Climate change-related risks and opportunities
- How these risks and opportunities are managed through targets and KPIs
- How climate change is addressed in corporate governance
- How climate risk impacts strategy

Additionally, large UK companies are required to report on their UK energy use and carbon emissions within their annual reports through the Streamlined Energy and Carbon Reporting.

Further, in 2023 ESG reporting in the UK will be further formalized through the Sustainability Disclosure Requirements (SDRs). The SDRs will provide a framework for corporates to manage sustainability-related risks, opportunities, and impacts, as well as set relevant metrics and targets.

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The following table showcases the evolution of sustainable development reporting in the recent past:



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6. EVOLUTION OF ESG IN INDIA

In India, the Ministry of Corporate Affairs (MCA) took the initiative to guide the corporates towards responsible conduct and a sustainable future by issuing Corporate Social Responsibility Voluntary Guidelines in December 2009.

The "Voluntary Guidelines on Corporate Social Responsibility", announced by the MCA in 2009, was one of the earliest initiatives taken by the Government of India. Its ultimate goal was to integrate sustainability into business practices and into decision making process.

The MCA further issued additional guidelines, known as the "National Voluntary Guidelines on Social, Environmental, and Economic Responsibilities of Business, 2011" (NVGs), emphasising the importance of corporate entities' environmental, social, and economic responsibilities, as well as the need to integrate them into business practices and investment decision making processes.

2009 – 'Corporate Social Responsibility Voluntary Guidelines 2009'

MCA issued CSR voluntary guidelines for the businesses to add value to the operations and contribute towards the long-term sustainability of the business. The most important element of these was to encourage the corporates to focus on Ethical functioning, Rights and welfare of workers, Human Rights, Environmental development and taking social development activities.

2011 – 'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business'

In July 2011 'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business' came which contained comprehensive principles to be adopted by companies as part of their business practice.

2012 – SEBI Mandates top 100 listed companies to file Business Responsibility Report

Top 100 listed companies by market capitalization were required to file Business Responsibility Report (BRR). This report was in line with the ESG principles.

2015 – BRR became part of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015

SEBI vide Circular no. CIR/CFD/CMD/10/2015 dated November 04, 2015, had prescribed the format for the Business Responsibility Report (BRR) in respect of reporting on ESG (Environment, Social

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and Governance) parameters by listed entities in line with clause (f) of sub regulation (2) of regulation 34 of SEBI(LODR) Regulations 2015. Top 500 listed companies by market capitalization were required to file Business Responsibility Report (BRR).

2017 – SEBI recommended Integrated Reporting for top 500 listed companies

On 6 February 2017, SEBI issued a circular advising top 500 listed companies which are required to prepare BRR to adopt IR on a voluntary basis from the financial year 2017-18.

2019 - National Guidelines on Responsible Business Conduct (NGRBC) 2018

MCA revised the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business, 2011 (NVGs) and formulated the National Guidelines on Responsible Business Conduct (NGRBC).

2019 – BRR became mandatory for top 1,000 listed companies

As per SEBI (Listing Obligations and Disclosure Requirements) (Fifth Amendment) Regulations, 2019, with effect from December 26, 2019, the annual report of the top 1,000 listed entities based on market capitalization shall contain a business responsibility report as per clause (f) of sub regulation (2) of regulation 34 of Listing Regulations.

2021 - New reporting requirements on ESG parameters called the Business Responsibility and Sustainability Report (BRSR).

Under notification no. SEBI/LAD-NRO/GN/2021/22 dated May 05, 2021, SEBI introduced new reporting requirements on ESG parameters called the Business Responsibility and Sustainability Report (BRSR).

The BRSR seeks disclosures from listed entities on their performance against the nine principles of the 'National Guidelines on Responsible Business Conduct' (NGBRCs) and reporting under each principle is divided into essential and leadership indicators.

The essential indicators are required to be reported on a mandatory basis while the reporting of leadership indicators is on a voluntary basis. Listed entities should endeavour to report the leadership indicators also.

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The BRSR is intended towards having quantitative and standardized disclosures on ESG parameters to enable comparability across companies, sectors, and time.

2009 National Voluntary Guidelines (NVGs) *(MCA issued NVGs on corporate social responsibility)*	2012 Business Responsibility Report (BRR) *The top 100 listed companies file BRR based on NVGs along with their annual reports*	2014 Corporate social responsibility (CSR) *CSR is mandated, and CSR Rules come into force*	2015 Extension to top 500 listed companies for filing BRR	2017 Integrated Reporting (IR) *IR may be adopted on a voluntary basis from FY 2017–18 by the top 500 companies which are required to prepare BRR*	2019 - National Guidelines on Responsible Business Conduct (NGRBC) released - Extension to the top 1,000 listed companies for filing BRR	2021 Business Responsibility and Sustainability Report (BRSR) *Introduction of BRSR in May 2021*	2022 Mandatory reporting of top 1,000 listed companies to file BRSR along with the annual reports
							

7. INITIATIVES BY ICAI

In Feb 2020, ICAI constituted Sustainability Reporting Standards Board (SRSB). Mission of the SRSB is to take appropriate measures to increase awareness and implement measures towards responsible business conduct, developing audit guidance for Integrated Reporting

ICAI, encouraged by SEBI, introduced India's first award to celebrate the business practice of Integrated Reporting, internationally acknowledged as the emerging best practice in corporate reporting

ICAI has also started a Certificate Course on Sustainable Development Goals (SDGs), Business Responsibility Reports (BRR), Integrated Reporting (IR) & also proposed an ICAI Executive Development Program on Business Responsibility Reporting (BRR)

In last 2 years, ICAI has issued following publications:

- Standard on Assurance Engagements (SAE 3410) – Assurance Engagements on Greenhouse Gas Statements
- Background Material on BRSR (revised 2021)
- Sustainable Development Goals – Accountants creating sustainable World – Parts 1 covering SDGs 1 to 5

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- Sustainable Development Goals – Accountants creating sustainable World – Parts 1 covering SDGs 6 to 11
- Sustainable Development Goals – Accountants creating sustainable World – Parts 1 covering SDG 12 to 17
- FAQs on Sustainability Reporting – Heart of Good Governance
- Sustainability Reporting Maturity Model (SRMM) – Version 1.0

7.1 BUSINESS RESPONSIBILITY AND SUSTAINABILITY REPORT (BRSR)

Reporting under BRSR is mandatory from financial year 2022-23. However, disclosure was voluntary in financial year 2021-22.

The reporting questionnaire is divided into three sections:

(i) Section A – General Disclosures

This section contains the details of the listed companies, its products, services, operations, employee related details, its holding, subsidiary, associate companies etc.

(ii) Section B – Management Process and disclosures

It contains questions related to policy and management processes, governance, leadership, and oversight.

(iii) Section C – Principle-wise performance disclosures

Companies are required to report upon Key performance indicators (KPIs) in alignment with the nine principles of the NGRBC. The section classifies KPIs into two categories that companies are required to report upon:

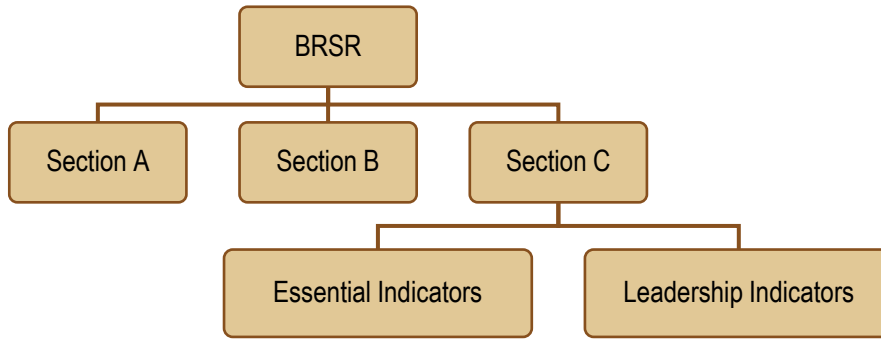
- Essential indicators (Mandatory disclosures)

This would include data on training programs conducted, environmental data on energy, emissions, water, waste management etc.

- Leadership indicators (Optional disclosures)

It would include life cycle assessments, details of conflict management policy, additional data on biodiversity, energy consumption, supply chain managements etc.

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7.1.1 Nine Principles of BRSR

The nine principles in BRSR are categorized into the ESG components of Environment, Social and Governance with two of the nine in Environment, three in social and four in Governance. Even though they are separate, they are interlinked to each other in some way. For example, environmental protection is closely linked to stakeholder engagement and inclusive growth.

Principle 1 – Ethics, Transparency and Accountability:

The first principle emphasizes that the business decisions in an organisation should be open to disclosure and accessible to the relevant interested parties.

The essence of the core elements associated with the first principle are:

a) The entities' governing structure should develop policies, procedures, and practices for their offices, factories, and work areas, ensuring that ethics is not compromised.

b) The information relating to the policies, procedures, and practices along with the performance should be made available to the stakeholders.

c) In case of adverse effects, more care has to be taken for transparent disclosures.

d) The entities in the value chain should be encouraged to adopt these principles by the governance structure.

e) The entities should proactively respond to the outside entities that violate the nine principles of the BRSRs. This includes their suppliers, distributors, sub-contractors, or regulatory officers that may engage with the business concern.

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Principle 2 – Safe and Sustainable Goods and Services:

The entities should make sure that their goods, services, and the operations result in better life for the consumers and end-users.

The essence of the core elements associated with the second principle is:

a) When a product is designed by the entity, the production methods and technologies have to be devised in such a way so as to minimize the resource usage to make it sustainable.

b) The entities are also responsible to educate and make aware their consumers and clients about their rights.

c) The entities should take measures that reduce the over exploitation of the nature's resources by consuming sustainably and encourage methods for reduce, reuse and recycling of the resources.

Principle 3 – Promote Well-Being of All Employees Including those in the Value Chain:

The third principle relates to all the initiatives an entity has to take for the benefit of its employees from the point of view of their dignity, health, well-being.

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The essence of the core elements associated with the principle is:

a) The entity should ensure compliance with all regulatory requirements as far as employees are concerned.

b) The entities are to respect the dignity of employee as a human being and should not restrict their freedom of associations, unions, and other participatory mechanism for collective bargaining of their rights and redressal of issues they face at the workplace.

c) The entities should prevent all kinds of child labour, bonded labour, and any other forms of involuntary labour.

d) The entities should have a system in which the work-life balance of the employees is not compromised.

e) The businesses have to ensure timely payment of the worker's wages and compensation.

f) The payment of the wages has to be as per the living wages, that can take care of the basic needs and provide economic security to the employees.

g) The entities are responsible to create a workplace and work environment that is safe, hygienic, and comfortable for people to work for long durations.

h) The skill development, career development and training of the workforce is another responsibility of the entities employing them.

i) The creation of a workplace which is free of harassment and violence is also a responsibility of the entity.

Principle 4 - Respect for Stakeholders' Interests and Responsiveness:

The concept of interested party or stakeholders to a business has been a point of discussion in all the regulatory and voluntary systems that relate to the management system of any organisation, be it related to the quality, environment or the occupational health and safety of the workers.

The essence of the core elements associated with the principle is:

a) The entities have to be transparent and communicate with the stakeholders about the impacts of their operations and business decisions on the people and the nature. The policies, decisions, and the impact of the operations of the organisation to the stakeholders have to be disclosed transparently with no ambiguity on the extent of the issues.

b) The entities have to systematically determine the context of their operation and identify their interested parties.

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c) The entities should fairly share the benefits to the stakeholders or give an opportunity to them to benefit from the operations in an equitable manner.

Principle 5 - Respect and Promote Human Rights:

The concept of human rights is a vast topic that covers a wide variety of violence and belligerent abusive issues faced by people. It refers to the human rights issues that happen directly or indirectly due to the operation of the business.

The essence of the core elements associated with the principle are:

a) The entities should have a clear understanding of the human rights and various ways by which human rights can be violated from the perspective of the Constitution of India, national laws and policies and the content of International Bill of Human Rights.

b) The entities when developing their management systems, should integrate the human rights element into their policies, procedures, and practices.

c) Businesses should recognize and respect the human rights of all relevant stakeholders and groups within and beyond the workplace, including that of communities, consumers, and vulnerable and marginalized groups.

Principle 6 – Protection and Restoration of Environment:

The sixth principle looks at the environmental responsibility as a basic requirement for the economic prosperity and sustainability.

The core elements associated with the principle are:

a) The entities should have policies, procedures, and practices in place to assess and rectify impacts to the environment. This should cover the whole life cycle of the product.

b) The entities have to make use of natural and manmade resources in an optimum manner to ensure their sustainability by taking feedback from the stakeholders.

c) The entities have to measure their performance relating to the prevention of pollution, destruction of forests, waste generation, energy use, land use, etc.

d) The entities have to contribute towards climate change resilience in line with India's commitment to various international mechanisms such as, Paris Agreement and National Action Plans for Climate Change.

e) The entities should explore the comparison of its activities with industry best practices to reduce, reuse and recycle/ recover materials, resources.

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f) The companies have to look out for avenues by which they can improve their performance towards various environmental responsibilities.

Principle 7 – Influence on Public and Regulatory Policy:

The seventh principle of influencing the policy formulation positively recognizes that the businesses operate within the framework of statutory and legislative policies of the governing authority.

The principle further highlights that -

a) The core elements of BRSR are to have met holistically when the organisation go ahead with their contributions to policy formulation and policy advocacy.

b) The collective associations such as, the trade groups and industry chambers have to be utilized when moving ahead with the policy advocacy and formulation.

c) The role in policy advocacy by the organisation should be in such a way that it encourages fair competition and prevents human rights abuses.

Principle 8 – Promote Inclusive Growth and Equitable Development:

This can work only with close participation and collaboration amongst the entities, authorities, the civil associations contributing to one another for a better livelihood, and assistance to the marginalized communities.

The core elements of the eighth principle are:

a) The entities should have systems in place to identify and address impacts of their activities on the social, cultural, and economic aspects of the people. This includes business created issues like, land acquisition and use and construction activities for new facilities.

b) The entities should review, measure, and track the adverse impacts of their activities on the society and environment and make action plans to mitigate them adequately.

c) The entities should make efforts to bring up creative products, technologies, and business concerns that help the marginalized communities to have well-being and a better quality of life.

d) Entities when designing their CSR activities should review the local and regional development priorities to help the marginalized groups and communities.

e) The entities should take care to ensure that business induced displacement or relocation of communities does not happen, and in unavoidable cases, should make sure to have mutually

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agreed, participative, and informed negotiations to provide fair compensation to the affected people.

f) All forms of intellectual property and traditional knowledge should get the deserved respect from the organisation, and efforts should be made to ensure that benefits derived from their knowledge are shared equitably.

Principle 9 – Provide Value to the Consumers in a Responsible Manner:

The primary purpose of any business is to create or provide useful products and services to the customer in exchange of reasonable profits.

The core elements associated with the principle are:

a) Entities should put in their efforts to reduce the negative impacts of their products and services on consumers, natural environment, and society at large.

b) When conceptualizing, designing, and marketing their products, the organisation should not in any manner prevent the freedom of choice and fair competition.

c) The entities should transparently and accurately disclose all kinds of adverse impacts to the user, planet, society, on the biodiversity from their products.

d) When handling customer data, the right to privacy of the customer needs to be maintained.

e) Entities should inform the customers on the safe and responsible ways of usage, reuse, recycling, and disposal of their products, and ways to eliminate over-consumption.

f) When advertising about their products, the organisations should ensure that misleading and confusing information is not exposed to the customers about their products or its usage.

g) Business enterprises should make available transparent and accessible grievance redressal and feedback management system for their customers to raise their voices or to seek clarifications.

h) Entities, when in the business of providing essential goods and services (e.g., Utilities), should enable universal access, including to those whose services have been discontinued for any reason, in a non-discriminatory and responsible manner.

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7.1.2 Allignment of BRSR Principles with SDGs

Principles/ SDGs	P1	P 2	P 3	P 4	P 5	P 6	P 7	P 8	P 9
SDG 1			☑	☑				☑	
SDG 2		☑				☑	☑	☑	☑
SDG 3			☑					☑	
SDG 4			☑					☑	☑
SDG 5			☑	☑	☑			☑	
SDG 6		☑				☑		☑	
SDG 7		☑				☑	☑		
SDG 8		☑	☑		☑			☑	
SDG 9		☑					☑		
SDG 10		☑					☑		
SDG 11			☑	☑			☑	☑	
SDG 12		☑				☑			☑
SDG 13		☑				☑	☑	☑	
SDG 14		☑				☑	☑	☑	☑
SDG 15		☑				☑	☑	☑	☑
SDG 16	☑		☑	☑	☑			☑	
SDG 17	☑						☑	☑	

7.1.3 Assurance in BRSR

SEBI has currently started with the top 1,000 listed companies. But very soon, remaining listed companies would also need to comply with the provisions of BRSR.

Further, BRSR is expected to be used as a single means for disclosing sustainability related information in India. This would be the main document which the stakeholders, investors would review and do industry analysis.

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Hence, assurance in this reporting becomes more critical. ESG audit would be a process that would help the companies to evaluate the environmental and social risks for the Company's products, services, operations etc. Conducting an ESG audit also helps businesses look at their supply-chain risks, risk management capabilities and transparency with shareholders.

ICAI has recently issued **Standard on Sustainability Assurance Engagements (SSAE) 3000** ***Assurance Engagements on Sustainability Information***

This Standard deals with assurance engagements on an entity's sustainability information. This is an umbrella standard applicable to all assurance engagements on Sustainability information.

The intended users of this Standard include:

- Assurance providers providing assurance on sustainability information.
- Entities seeking to engage a professional auditor.
- Regulators, investors, and other users of Sustainability Reporting data.

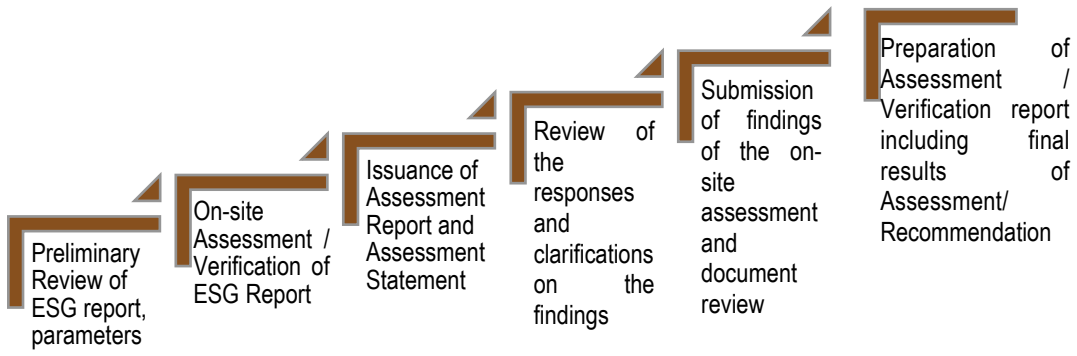
This Standard applies for assurance engagements which pertain to providing reasonable or limited assurance on sustainability information.

The effective date of application of SSAE 3000 is as follows:

- Voluntary basis for assurance reports covering periods ending on 31st March 2023.
- Mandatory basis for assurance reports covering periods ending on or after 31st March 2024.

ICAI has also issued SAE 3410, *Assurance Engagements on Greenhouse Gas Statements* which deal with assurance engagements on an entity's sustainability information including assurance of BRSR.

7.1.4 Methodology to provide assurance on BRSR:



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7.1.5 Social Audit Standards

The Sustainability Reporting Standards Board (SRSB) of the ICAI has recently issued Social Audit Standards (SAS 100 to 1600). These Standards aim to provide the Social Auditor with the necessary guidance in relation to independent impact assessment engagement of Social Enterprises engaged in various areas and the audit steps and procedures that should be applied while conducting the social impact assessment. The Standard sets out the minimum requirements to be followed while conducting impact assessment. Laws or regulations may establish additional requirements which should be followed, as applicable. Following SASs are issued:

SAS	Particulars
100	Eradicating hunger, poverty, malnutrition and inequality
200	Promoting health care including mental healthcare, sanitation and making available safe drinking water
300	Promoting Education, Employability, and Livelihoods
400	Promoting Gender Equality, Empowerment of Women and LGBTQIA+ communities
500	Ensuring environmental sustainability, addressing climate change including mitigation and adaptation, forest and wildlife conservation
600	Protection of national heritage, art and culture
700	Training to promote rural sports, nationally recognised sports, Paralympic sports and Olympic sports
800	Supporting incubators of social enterprises
900	Supporting other platforms that strengthen the non-profit ecosystem in fundraising and capacity building
1000	Promoting Livelihoods for rural and urban poor including enhancing income of Small and Marginal Farmers and workers in the non-farm sector
1100	Slum area development, affordable housing and other interventions to build sustainable and resilient cities
1200	Disaster Management, including Relief, Rehabilitation and Reconstruction Activities
1300	Promotion of financial inclusion
1400	Facilitating Access to Land and Property Assets for disadvantaged Communities
1500	Bridging the digital divide in internet and mobile phone access, addressing issues of misinformation and data protection
1600	Promoting welfare of migrants and displaced persons

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8. ROLE OF AUDITOR - CONSIDERATION OF CLIMATE RELATED RISKS IN AN AUDIT OF FINANCIAL STATEMENTS

The role of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, to enable auditor to report whether the financial statements are prepared and presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

In developing the understanding of an entity, the auditor should include the consideration of climate-related risks and how these risks may be relevant to the audits. The climate-related risks could be more relevant in certain sectors or industries, e.g., banks and insurance, energy, transportation, materials and buildings, agriculture, food, and forestry products.

Many investors and stakeholders are seeking information from auditor's reports about how climate-related risks were addressed in the audit. With this increased user focus on climate change, auditor need to be aware of, and may face, increasing pressure for transparency about climate matters in our auditor's reports. However, the auditor's reports must follow the requirements of applicable auditing standards.

The auditor's report is a key mechanism of communication to users about the audit that was performed. In addition to the audit opinion, it provides information about auditor's responsibilities and, when required, an understanding of the matters of most significance in our audit and how they were addressed.

In some circumstances, it may warrant inclusion of an Emphasis of matter paragraph to draw attention to disclosures that are of fundamental importance to users' understanding of the financial statements. The auditor should also determine whether the entity has appropriately disclosed relevant climate-related information in the financial statements in accordance with the applicable financial reporting framework e.g., Indian Accounting Standards or Accounting Standards, when relevant before considering climate-related matters in the auditor's report.

The auditor should also read the other information for consistency with information disclosed in the financial statements and information that may be publicly communicated to stakeholders outside the financial statements, such as management report narratives in the annual report, press releases, or investor updates. This is a requirement under ISA 720 and SA 720, The Auditor's Responsibilities Relating to Other Information.

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Case Study

The agrochemical sector is about a $35 billion industry in India. The Indian agrochemicals market is segmented by product type (fertilizers, pesticides, adjuvants, and plant growth regulators) and application (crop-based and non-crop-based). India is one of the most prominent exporters of agrochemicals in the world and is being keenly looked at as an ideal hub for export-oriented production of agrochemicals. There has been a recent surge in the production of agrochemicals to overcome problems such as lack of right nutritious elements required for proper growth of crops, etc. While there is low awareness about the use and impact of agrochemicals, there is also a push from the industries to use more agrochemicals, linking it to better yield. The continuous and increased use of agrochemicals seems to have an adverse effect on humans, animals, and nature in whole.

The toxicity levels of the agrochemicals are harmful, not only to the workers in the manufacturing process but also to farmers, the soil, and the end consumers. The Central Insecticide Board (CIB) of India has categorized agrochemical toxicity levels based on a labeling system—using red, yellow, blue, and green labels—where red is the most toxic and green is the least. Most of the red-labeled products are banned abroad but are being sold in India due to the lack of a strong regulatory environment.

In India, it is estimated that almost 25% of the total amount of agrochemicals sold are counterfeit products. The quality and the efficacy of these counterfeit products differ from the original products, which can lead to reputational damages for the companies. Agrochemical companies need to add barcodes or other identifying technologies to their product packaging, to allow end-use consumers to check for authenticity. Also, since India is a multilingual country, the companies will have to publish the usage instructions in multiple languages.

Company A and B are both listed companies and part of top 1000 listed companies. They are engaged in the production of agrochemicals. Company A has been looking for opportunities to comply with the recently launched and evolving guidelines for ESG in India while Company B on the other hand is just focused to increase revenue and profits. In December 2023, Company A made a decision to eliminate red-labeled products from its portfolio and to increase its research and development (R&D) spending to safeguard itself from the market shift due to the new regulatory norms; in 2023, it also discontinued yellow-labeled products. Company A is also planning to incur a small expenditure to improve their backend systems and provide for all its products a unique labeling system that is user friendly and interactive. At the other end of the spectrum, 14% of Company B's top-selling products are derived from red- and yellow labeled products.

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Initially, Company A's phasing out of its toxic products negatively affected its revenues by 8%. But as the country's regulatory landscape evolves toward more stringent norms, Company A will be cushioned for regulatory changes and thus, would not face potential future downsides. Company B has recently witnessed a 9% year on year growth in revenue from the last financial year and is planning to increase the production of its bestselling product, an insecticide DDT, categorized as red labelled by the Central Insecticide Board. Company B has recently been approached by the regulatory authority for an investigation for its products which include performing additional tests and studies to testify that its products have no adverse effects.

1. What would be the reporting requirements for each of the two companies?
2. Which Company has absorbed the impacts of possible future regulatory changes? What are the steps taken by that Company for complying with the regulatory standards?
3. What would be the consideration by the auditors of Company A and B in the audit of financial statements?

9. CONCLUSION

The overarching importance of sustainability reporting continues to gain momentum globally with demands from various stakeholders and substantial research and developments toward a uniform set of sustainability standards. The uniformity is not achieved yet due to lack of a common language for sustainability reporting. As reporting of sustainability information becomes the trend being observed globally, the demand for independent assurance of sustainability information is anticipated to grow as entities around the globe look to enhance the integrity of their sustainability reporting. Hence, it is imperative that auditors and assurance providers understand the current landscape and continue to monitor ongoing developments. The demand for assurance on "sustainability branded" reporting continues to grow and therefore there is an urgent need for globally accepted sustainability/ ESG assurance standards that can be used by all assurance professionals.

Key Takeaways

- Sustainable development is development that strives to meet the needs of developing countries seeking to achieve a more sustainable world. Sustainable development addresses the needs of the present moment without compromising current and future generations to meet their own sustainable lifestyles.
- Environment, social and governance form three pillars of ESG. Environmental, social and governance (ESG) reporting is all about disclosure of information, data, metrics that explain

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and added value in these three areas. ESG reporting can be both quantitative and qualitative in nature.

- Sustainable Development Goals (SDGs) are set of 17 goals in line with the 2030 Agenda for Sustainable Development" adopted by UN.
- International investors with global investment portfolios are increasingly calling for high quality, transparent, reliable, and comparable reporting by companies on climate and other environmental, social and governance (ESG) matters.
- The Integrated Reporting Framework is used to connect financial statements and sustainability-related financial disclosures. It has been established to develop high-quality, understandable, enforceable and globally accepted accounting and sustainability disclosure standards.
- The Integrated reporting framework identifies 6 capitals- financial capital, manufactured capital, natural capital, human capital, social capital and intellectual capital.
- ESG disclosure and reporting is mandatory for top 1000 listed companies in form of Business responsibility and sustainability reports. (BRSR).
- As reporting of sustainability information becomes the trend being observed globally, the demand for independent assurance of sustainability information is anticipated to grow as entities around the globe look to enhance the integrity of their sustainability reporting.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *What type of companies are required to mandatorily furnish the Business Responsibility and Sustainability Report (BRSR) as per the SEBI circular with effect from FY 2022-23?*
2. *What are the nine principles of BRSR? How are the nine principles of BRSR linked with the 17 UN Sustainable Development Goals?*
3. *What are the global trends in sustainable reporting?*
4. *What are the 6 C's of Integrated reporting?*
5. *What is the methodology of providing assurance in BRSR?*
6. *What is the auditor's role on ESG aspects in an audit of financial statements of the Company?*

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7. ***CTO Limited is engaged in the fintech business. It is a member of few prominent industry chambers and trade associations and has come under mandatory purview of Business Responsibility and Sustainability Reporting (BRSR) for year 2022-23.***

   The company had submitted inputs on draft digital personal data protection bill to concerned Ministry during year 2022-23. It had also submitted to one of the industry chambers during the same year certain key inputs on leveraging India's digital public infrastructure for creating solutions by banks and fintechs together as its taskforce member on the subject. Considering the above, discuss how above information would likely be disclosed by company in "Principle-wise performance disclosures" as part of BRSR for year 2022-23?

   Whether information discussed above would require to be disclosed mandatorily?

8. ***SEBI has made Business Responsibility and Sustainability Report (BRSR) mandatory for certain listed companies. It is an evolutionary step in Environment, Social and Governance (ESG) reporting. Discuss the nature of ESG reporting. How can corporates contribute to Sustainable Development Goals (SDGs)?***

9. ***SU Limited is amongst the top 1000 listed entities. With the introduction of new reporting requirements by SEBI on ESG parameters called the Business Responsibility and Sustainability Report (BRSR), it requires SU Limited to make disclosures on their performance against the various principles of the "National Guidelines on Responsible Business Conduct". One of the principles emphasizes that the business decisions in an organization should be open to disclosure and accessible to the relevant interested parties. Elucidate the essence of core elements associated with the aforesaid principle.***

Answers to Test your Understanding

1. Sustainability reporting is an organization's practice of reporting publicly on its economic, environmental, and/or social impacts, and hence its contributions – positive or negative – towards the goal of sustainable development

Sustainability reporting refers to the information that companies provide about their performance to the outside world on a regular basis in a structured way. It is the comprehensive mechanism of measuring and disclosing sustainability data with performance indicators and management disclosures.

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Expected Benefits: It can help stakeholders to understand organizations performance vis a vis sustainability and impacts. The reporting process emphasizes the link between financial and non-financial performance.

Such reporting can help entities to focus on long-term value creation, by addressing environmental, social and governance (ESG) issues. Since investors are increasingly recognising that environmental and social issues provide both risks and opportunities in respect of their investments and are seeking disclosures on the environmental and social performance of businesses, they can use ESG performance of companies to make investment decisions.

Investing in social and environmental issues will not only improve own business continuity of companies but also put them in a better position with their B2B (Business to Business) customers as well as enable them to acquire new ones.

2. The information at [i] states that company has increased the number of customers using digital mobile app. Besides, it has led to a 100% increase in digital collection. Therefore, it involves the use of technology for deriving business benefits. It has invested in innovation deriving business benefits from digitization. The capital referred to at [i] is "Intellectual Capital".

An increase in number of beneficiaries under flagship CSR programmes providing value for communities and sustainable livelihood is an example of relationships established within and between each community, group of stakeholders and other networks to enhance individual and collective well-being. The capital referred to at [ii] is "Social and Relationship Capital."

Answers to Case Study

1. Both Companies A and B are among part of top 1000 listed companies. Hence, these companies have to mandatorily provide BRSR reporting (Business responsibility and Sustainability reporting) in accordance with 9 principles of NGBRC as mandated by SEBI.

2. Company A has absorbed impact of regulatory changes. It has decided to eliminate red-labelled and yellow-labelled products from its portfolio which are toxic in nature. Besides, it has increased its expenditure on R & D to meet with new regulatory norms. It has also incurred expenditure for improving its labelling system which would help end users to know about the nature of the product. All these steps have been taken by Company A for complying with regulatory standards.

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Company A is trying to meet with requirements of Principle 2 by making R & D expenditure. Further, it has also eliminated red-labelled/yellow-labelled products from its portfolio. Principle 2 relates to the requirement that businesses should provide goods and services in a manner that is sustainable and safe. Besides, by adopting a friendly bar-coded packaging labelling system, company is adhering to requirements of Principle 9 which states that businesses should engage with and provide value to their consumers in a responsible manner. Steps taken by a company to inform its consumers about safe and responsible usage of products fall in its domain.

Since toxic agrochemicals are also harmful to workers engaged in their manufacturing process, their discontinuation bodes well for workers in the company A in line with Principle 3 which states that businesses should respect and promote the well-being of all employees including those in their value chains. By discontinuing products which are harmful to soil, company A is meeting requirements of Principle 6 which states that businesses should respect and make efforts to protect and restore the environment.

3. Company A is complying with regulatory norms whereas 14% of company B's revenue are derived from red and yellow labelled products. In fact, company B is planning to increase production of its red labelled product i.e., insecticide DDT which has been categorized as such by Central Insecticide Board. The auditor of Company B would have to keep in mind requirements of SA 250 in this regard. Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements. It can result in material misstatements. Central Insecticide Board has already launched its investigation into products of company. All these factors would be taken into consideration by auditor of Company B.

Auditors of Company A and Company B need to obtain audit evidence regarding compliance with laws and regulations and audit procedures have to be designed accordingly. Auditor of Company A can obtain assurance from regulatory compliance by the company. Fall of revenue by 8% in one year is not a matter of concern to them as it is a transitory phase.

However, auditors of Company B would also have to take into consideration requirements of SA 570 as non-compliance with regulatory requirements could result into claims from such proceedings which the company may not be able to satisfy.

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Hints /Answers to Theoretical Questions

1. Refer para 7.1.

2. Refer para 7.1.1.

3. Refer para 3.

4. Refer para 4.

5. Refer para 7.1.4.

6. Refer para 8.

7. ***The given case highlights that CTO Limited, engaged in Fintech business, is a member of Chamber of Commerce/associations. Such information needs to be disclosed under Principle 7 of Principle-wise Performance Disclosures.***

Principle 7 recognizes that businesses, when engaging in influencing public and regulatory policy, operate within the framework of statutory and legislative policies of the governing authority. Collective associations such as trade groups and industry chambers have to be utilized when moving ahead with policy advocacy and formulation.

The information under each principle is to be disclosed under Essential indicators (mandatory disclosures) and Leadership indicators (optional disclosures).

Information relating to membership of Chamber/associations is in the nature of Essential Indicators and requires mandatory disclosures.

Information relating to inputs provided by company to the Ministry on a legislative bill and inputs provided to one of the prominent chambers on leveraging India's digital public infrastructure for creating solutions by banks and Fintechs together as a taskforce member on the subject are in nature of leadership positions taken by the company. These are in the nature of Leadership Indicators and are optional disclosures.

8. ***Refer para 1.***

ESG reporting can be both quantitative and qualitative in nature. Qualitative reports tend to describe a company's strategy or policy around the relevant topics, while a quantitative approach includes metrics, and key performance indicators (KPIs) linked

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to each area in order to measure progress against goals and report on achievements. Naturally, a mixed approach that makes use of both qualitative and quantitative information tends to add the maximum value to the quality of disclosures.

United Nations members states adopted Sustainable Development to provide a blueprint which mentioned the Sustainable Development Goals (SDGs). They recognized that ending poverty and other deprivations must go hand in hand with strategies that improve health and education, reduce inequality, and spur economic growth – all while tackling climate change and working to preserve our oceans and forests.

Corporates can contribute to SDGs due to their capacity to provide solutions necessary for meeting SDGs. Companies can lead in innovation and contribute to achievement of Sustainable Development Goals.

9. Refer para 7.1.1 Principle 1.

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CHAPTER 19

PROFESSIONAL ETHICS & LIABILITIES OF AUDITORS



LEARNING OUTCOMES

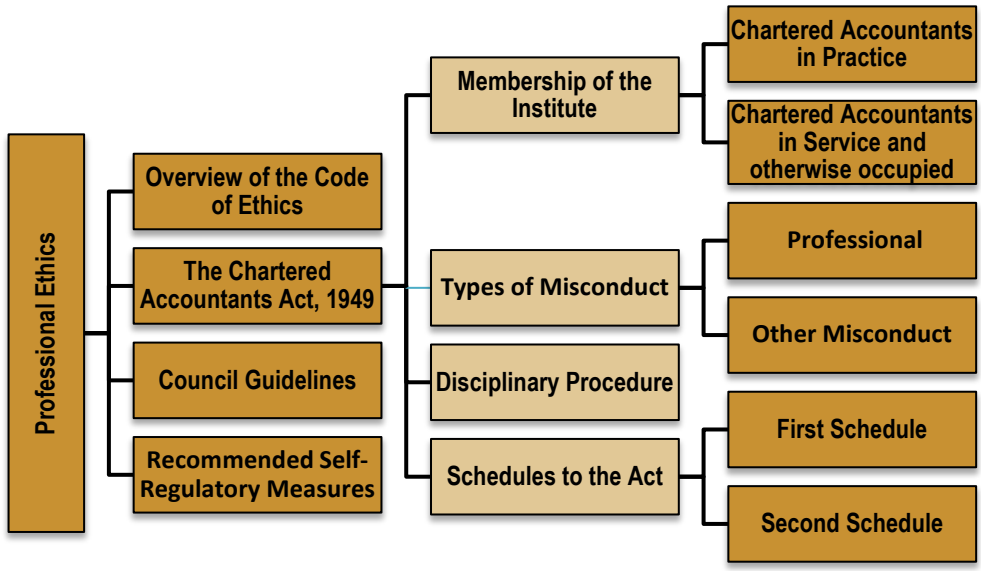
After reading this chapter student shall be able to:

- Understand the application of the International and Indian Code of Ethics theoretically/practically.
- Learn the application of Fundamental Principles of Professional Ethics by Professional Accountants in practice, service or otherwise occupied.
- Identifying threats and safeguards measures while compliance of Fundamental Principles of Professional Ethics.

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CHAPTER OVERVIEW

This chapter encapsulates the relevant professional ethics guidelines, requirements and the standards of conduct expected from a Chartered Accountant. The Chapter has been divided into various sections to facilitate systematic and easy learning by the students.



CA R is one of the leading practitioners in Varanasi and is a partner in an audit firm consisting of 8 partners. The firm is allotted branch audit of a leading public sector bank in the same city having advances of ₹450 crore. The advanced portfolio of the branch consists of some reputed export firms.

It is noticed during audit that drawing power in stock statements submitted to bankers by these firms is not arrived at properly. There are no apparent errors as such. The issue he is raising can be overlooked, if he chooses to do so. Besides, his staff also digs out certain frivolous procedural irregularities in relation to these accounts. The accounts of all these firms are, otherwise, operating satisfactorily. He intends to report these accounts as NPAs in memorandum of changes and is creating headache for AGM every other day. Completion of audit is being delayed on one pretext or another. Even informal calls by Circle DGM prove to be futile. The amounts involved are huge and much is at stake for branch management.

Frustrated and harassed AGM of branch advises owners of these firms to meet CA R in his office and sort out the matter themselves. Out of 7 such firms, 3 owners meet him in his office and assure to avail services of his firm in immediate future. They also try to assuage his ego. He leaves out these accounts from reporting. Owners of the remaining firms do not meet him. Peeved by this, their loan accounts are reported as NPA and adverse comments are made in LFAR.

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Is Chartered Accountant acting ethically? The answer is resounding NO. He is trying to put his personal benefit and interest above all things. He is overlooking certain matters falling in his discretion selectively for obvious reasons. He is not looking at things objectively. A distinguishing feature of Chartered Accountancy profession is the acceptance of responsibility to act in public interest. Such a behavioural attitude is not expected from professionals. Ethics is something which comes from an individual intrinsically. It has to be ingrained in the temperament of an individual to withstand any selfish motive or temptation. It is a state of mind to act and perform in accordance with moral principles. Spirit of ethics is to be followed and not only what is expressly stated or codified.

Consider another case of a practicing Chartered Accountant who comes to know of certain information by virtue of his association with a client. He is also dealing with another client in same line of business. Can he use information acquired from first client to advantage or disadvantage of second client? Again, the answer would be in negative. As he could breach confidentiality by doing so. It can lead to conflict of interest. A professional accountant is not supposed to allow a conflict of interest to compromise professional or business judgment.

Professional work of accountants could involve ethical situations on a daily basis consisting of perceived benefits, pressures or dilemmas. There could be a thin line of difference between ethical and unethical. It requires judgment in every situation in accordance with spirit of ethics and its principles.

Exhaustive code of ethics is in place for public accountants. It not only contains fundamental principles governing professional ethics along with conceptual framework but also deals with independence requirements for assurance engagements. Besides, there are specific provisions of the Chartered Accountants Act, 1949 dealing with professional misconduct.

1. INTRODUCTION

The Oxford Dictionary states ethics as "the moral principle that governs a person's behavior or how an activity is conducted". It is the branch of knowledge that deals with moral principles, whereas *"Professional Ethics"* consist of personal, organizational and corporate standards of behaviour expected for professionals.

Chartered Accountants as professionals are engaged in building trust to vast variety of users, whether shareholders, government, banks, investors, employees or others, which imposes a public interest responsibility on their profession. Like other professionals, Chartered Accountants also have some set of code of ethics. **This Code of Ethics establishes ethical requirements for Professional Accountants.**

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A Chartered Accountant, either in practice or in service, has to abide by these ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their jobs. Service users of professionals should be able to feel secure that there exists a framework of professional ethics which governs the provision of those services. Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants.



Fig: Professional Ethics*

Code of Ethics– Its Necessity: Ethics are as old as human civilization. It is nothing but the laws or rules of acceptable behaviour. The whole foundation of any profession, particularly CA profession, is its credibility. The sole purpose of Code of Ethics is to ensure and uphold this credibility. The main ingredient of our profession is independence. An auditor needs to be independent while carrying out his audit. The provisions discussed in the same ensure that the independence of members of the Institute is not affected.

Our Institute's Motto – ***'Ya Esha Supteshu Jagrati'*** is adopted from Kathopanishad and it denotes 'eternal vigilance' – awakening when the world is asleep.

A distinguishing feature of the accountancy profession is its acceptance of the responsibility to act in the public interest. The Code of Ethics seeks to protect the interests of the profession as a whole. It is a shield that enables us to command respect.

2. OVERVIEW OF THE CODE OF ETHICS

The revised Code of Ethics contains the following material:

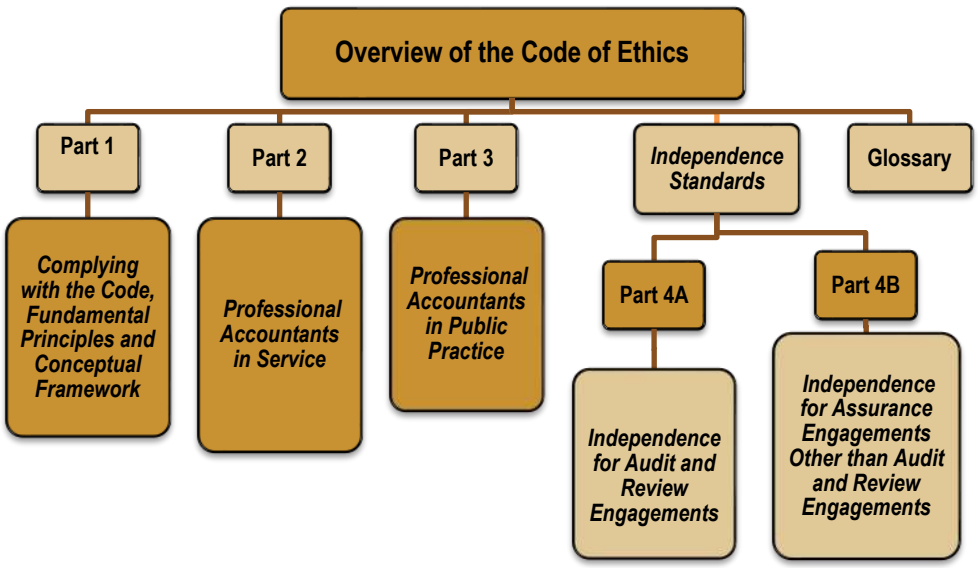
- **Part 1 –** Complying with the Code, Fundamental Principles and Conceptual Framework, which includes the fundamental principles and the conceptual framework and is applicable to all professional accountants.
- **Part 2 –** Professional Accountants in Service, which sets out additional material that applies to professional accountants in service when performing professional activities. Professional accountants in service include professional accountants employed, engaged or contracted in an executive or non-executive capacity in, for example:
    - Commerce, industry or service.
    - The public sector.
    - Education.

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- The not-for-profit sector.
- Regulatory or professional bodies.

Part 2 is also applicable to individuals who are professional accountants in public practice when performing professional activities pursuant to their relationship with the firm as an employee.

- **Part 3 –** Professional Accountants in Public Practice, which sets out additional material that applies to professional accountants in public practice when providing professional services.
  - **Independence Standards,** which sets out additional material that applies to professional accountants in public practice when providing assurance services, as follows:
  - **Part 4A – Independence for Audit and Review Engagements,** which applies when performing audit or review engagements.
  - **Part 4B – Independence for Assurance Engagements Other than Audit and Review Engagements,** which applies when performing assurance engagements that are not audit or review engagements.
- **Glossary,** which contains defined terms (together with additional explanations where appropriate) and described terms which have a specific meaning in certain parts of the Code. For example, as noted in the Glossary, in Part 4A, the term "audit engagement" applies equally to both audit and review engagements. The Glossary also includes lists of abbreviations that are used in the Code and other standards to which the Code refers.



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The Code contains sections which address specific topics. Some sections contain subsections dealing with specific aspects of those topics.

Each section of the Code is structured, where appropriate, as follows:

- **Introduction –** sets out the subject matter addressed within the section and introduces the requirements and application material in the context of the conceptual framework. Introductory material contains information, including an explanation of terms used, which is important to the understanding and application of each Part and its sections.
- **Requirements –** establish general and specific obligations with respect to the subject matter addressed.
- **Application material –** provides context, explanations, suggestions for actions or matters to consider, illustrations and other guidance to assist in complying with the requirements.

A professional accountant shall comply with the Code. There might be circumstances where laws or regulations preclude an accountant from complying with certain parts of the Code. In such circumstances, those laws and regulations prevail, and the accountant shall comply with all other parts of the Code.

2.1 Fundamental Principles

In order to achieve the objectives of the Accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles. The fundamental principles as discussed in Code of Ethics of ICAI, to be complied, are given below:



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(a) Integrity – Subsection 111

1. A professional accountant shall comply with the principle of integrity, **which requires an accountant to be straightforward and honest** in all professional and business relationships. Integrity implies fair dealing and truthfulness.

2. A professional accountant shall not knowingly be **associated with** reports, returns, communications or other information where the accountant believes that the information:

   (a) Contains a materially false or misleading statement;

   (b) Contains statements or information provided negligently; or

   (c) Omits or obscures required information where such omission or obscurity would be misleading.

   However, a professional accountant will ***not be considered to be in breach*** of matters mentioned above in paragraph 2 if the professional accountant provides a modified report in respect of such above mentioned matter.

3. When a professional accountant becomes aware of having been associated with information described in paragraph 2, the accountant shall ***take steps to be disassociated*** from that information.

(b) Objectivity- Subsection 112

A professional accountant shall comply with the principle of objectivity, which requires an accountant not to compromise professional or business judgment because of bias, conflict of interest or undue influence of others.

A professional accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

(c) Professional Competence and Due Care – Subsection 113

1. **A professional accountant shall comply with the principle of professional competence and due care,** which requires an accountant to:

   (a) Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and

   (b) act diligently in accordance with applicable technical and professional standards.

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2. **Serving** clients and employing organizations **with professional competence** requires **the exercise of sound judgment** in applying **professional knowledge** and **skill** when undertaking professional activities.

3. **Maintaining professional competence** requires a **continuing awareness** and an **understanding** of relevant **technical, professional and business developments**.

4. **Continuing professional development** enables a professional accountant to **develop** and **maintain** the **capabilities** to perform competently within the professional environment.

5. **Diligence** encompasses the **responsibility to act** in accordance **with the requirements** of an assignment, **carefully, thoroughly** and on a **timely** basis.

6. In **complying** with the **principle of professional competence and due care**, a professional accountant shall take reasonable steps to ensure that those working in a professional capacity under the accountant's authority have appropriate training and supervision.

Where appropriate, a professional accountant shall make clients, the employing organization, or other users of the accountant's professional services or activities, aware of the limitations inherent in the services or activities.

(d) Confidentiality- Subsection 114

1. A professional accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as a result of professional and employment relationships. An accountant shall:

Be alert to the possibility of inadvertent disclosure, including in a social environment, and particularly to a close business associate or an immediate or a close family member;
Maintain confidentiality of information within the firm or employing organization;
Maintain confidentiality of information disclosed by a prospective client or employing organization;
Not disclose confidential information acquired as a result of professional and employment relationships outside the firm or employing organization without proper and specific authority, unless there is a legal or professional duty or right to disclose;
Not use confidential information acquired as a result of professional and employment relationships for the personal advantage of the accountant or for the advantage of a third party;

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Not use or disclose any confidential information, either acquired or received as a result of a professional or employment relationship, after that relationship has ended; and

Take reasonable steps to ensure that personnel under the accountant's control, and individuals from whom advice and assistance are obtained, respect the accountant's duty of confidentiality.

2. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant in the knowledge that the information will not be disclosed to a third party. Nevertheless, the following are circumstances where professional accountants are or might be required to disclose confidential information or when such disclosure might be appropriate:

(a) Disclosure is ***required by law,***



- Production of documents or other provision of evidence in the course of legal proceedings.
- Disclosure to the appropriate public authorities of infringements of the law that come to light.

(b) Disclosure is ***permitted by law and is authorized by the client*** or the employing organisation;

(c) There is a ***professional duty or right to disclose***, when not prohibited by law:

(i) To comply with the requirements of Peer Review or Quality Review of the Institute;

(ii) To **respond** to an inquiry or investigation by a professional or regulatory body;

(iii) To **protect** the professional interests of a professional accountant in legal proceedings; or

(iv) To **comply** with **technical and professional standards**, including ethics requirements.

3. **In deciding whether to disclose confidential information, professional accountants should consider the following points:**

(a) Whether the interests of any party, including third parties whose interests might be affected, could be harmed if the client or employing organization consents to the disclosure of information by the professional accountant;

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(b)	Whether all the relevant information is known and substantiated, to the extent it is practicable; and
(c)	The proposed type of communication, and to whom it is addressed;
(d)	Whether the parties to whom the communication is addressed are appropriate recipients.

4. A professional accountant shall continue to comply with the principle of confidentiality even after the end of the relationship between the accountant and a client or employing organization. When changing employment or acquiring a new client, the accountant is entitled to use prior experience but shall not use or disclose any confidential information acquired or received as a result of a professional or employment relationship.

(e) Professional Behaviour- Subsection 115

1. A professional accountant shall comply with the principle of professional behaviour, which requires an accountant to comply with relevant laws and regulations and avoid any **conduct** that accountant knows or should know might discredit the profession.

   Conduct that might discredit the profession includes conduct that a reasonable and informed third party would be likely to conclude adversely affects the good reputation of the profession.

   A professional accountant shall not knowingly engage in any employment, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles.

2. When promoting himself and his work, a professional accountant shall not bring the profession into disrepute. A professional Accountant is required to conduct his affairs in a manner that he remains outside the boundaries of professional and other misconduct. A professional accountant shall be honest and truthful and should not make:

   (a) Exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or

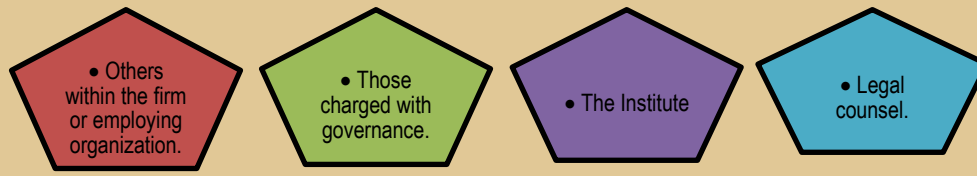
   (b) Disparaging references or unsubstantiated comparisons to the work of others.

   (c) Any direct or indirect measures to advertise any professional/other facts which are in violation of Advertisement Guidelines issued by the Council of the Institute from time to time.

   The professional accountant should ensure that the contents of an advertisement are true to the best of his knowledge and belief, and are in conformity with the Advertisement Guidelines, and be aware that the Institute does not own any responsibility, whatsoever, for such contents

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or claims by him. However, if a professional accountant is in doubt about whether a form of proposed advertising is appropriate, the accountant is encouraged to consult with the Ethical Standards Board of ICAI.

A professional accountant shall comply with each of the fundamental principles.
The fundamental principles of ethics establish the standard of behaviour expected of a professional accountant.
The conceptual framework establishes the approach which an accountant is required to apply to assist in complying with those fundamental principles.
A professional accountant might face a situation in which complying with one fundamental principle conflicts with complying with one or more other fundamental principles. In such a situation, the accountant might consider consulting, with: 
However, such consultation does not relieve the accountant from the responsibility to exercise professional judgment to resolve the conflict or, if necessary, and unless prohibited by law or regulation, disassociate from the matter creating the conflict.
The professional accountant is encouraged to document the substance of the issue, the details of any discussions, the decisions made and the rationale for those decisions.

2.2 Threats, Evaluation of Threats and Safeguards

The conceptual framework specifies an approach for a professional accountant to:

(i) Identify threats to compliance with the fundamental principles;

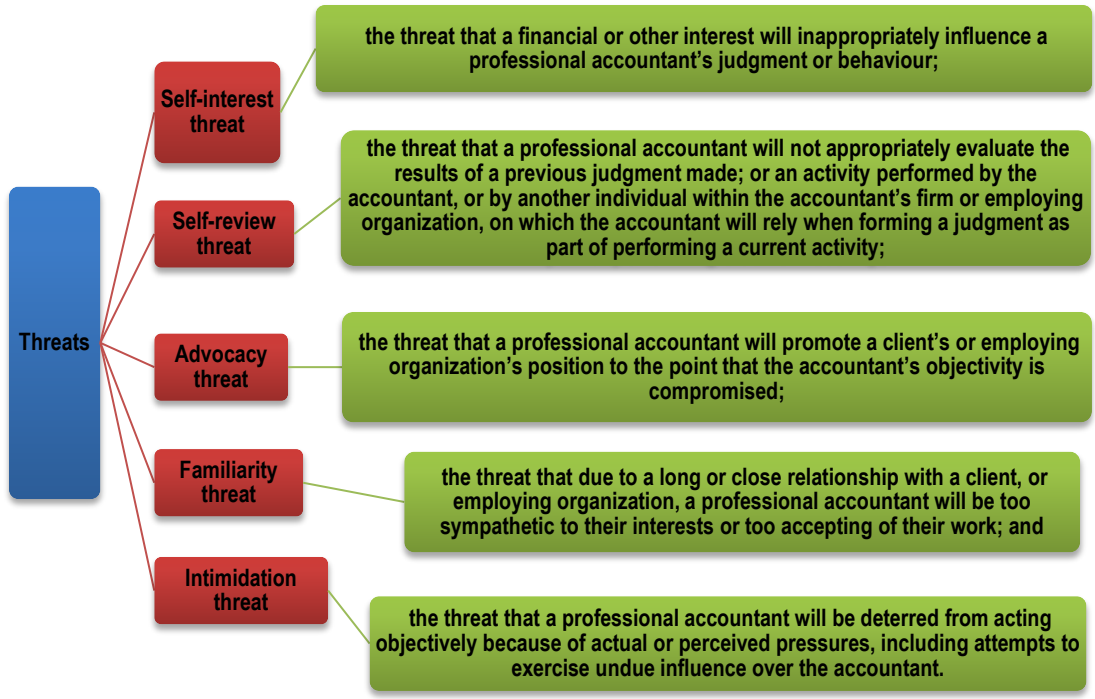
(ii) Evaluate the threats identified; and

(iii) Address the threats by eliminating or reducing them to an acceptable level.

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A. Threats

Threats to compliance with the fundamental principles fall into one or more of the following categories:



A. The following are examples of facts and circumstances within each of those categories of threats that might create threats for a professional accountant when undertaking a professional service:



Self-interest Threats

- A professional accountant having a direct financial interest in a client.
- A professional accountant quoting a low fee to obtain a new engagement and the fee is so low that it might be difficult to perform the professional service in accordance with applicable technical and professional standards for that price.
- A professional accountant having a close business relationship with a client.
- A professional accountant having access to confidential information that might be used for personal gain.
- A professional accountant discovering a significant error when evaluating the results of a previous professional service performed by a member of the **accountant's firm.**

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Self-review Threats

- A professional accountant issuing an assurance report on the effectiveness of the operation of financial systems after implementing the systems.
- A professional accountant having prepared the original data used to generate records that are the subject matter of the assurance engagement.



Advocacy Threats

- A professional accountant promoting the interests of, or shares in, a client.
- A professional accountant acting as an advocate on behalf of a client in litigation or disputes with third parties.
- A professional accountant lobbying in favor of legislation on behalf of a client.



Familiarity Threats

- A professional accountant having a close or immediate family member who is a director or officer of the client.
- A director or officer of the client, or an employee in a position to exert significant influence over the subject matter of the engagement, having recently served as the engagement partner.

An audit team member having a long association with the audit client.



Intimidation Threats

- A professional accountant being threatened with dismissal from a client engagement or the firm because of a disagreement about a professional matter.
- A professional accountant feeling pressured to agree with the judgment of a client because the client has more expertise on the matter in question.
- A professional accountant being informed that a planned promotion will not occur unless the accountant agrees with an inappropriate accounting treatment.
- A professional accountant having accepted a significant gift from a client and being threatened that acceptance of this gift will be made public.

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B. The following are examples of facts and circumstances within each of those categories that might create threats for a professional accountant when undertaking a professional activity:



Self-interest Threats

- A professional accountant holding a financial interest in, or receiving a loan or guarantee from, the employing organization.
- A professional accountant participating in incentive compensation arrangements offered by the employing organization.
- A professional accountant having access to corporate assets for personal use.
- A professional accountant being offered a gift or special treatment from a supplier of the employing organization.



Self-review Threats

- A professional accountant determining the appropriate accounting treatment for a business combination after performing the feasibility study supporting the purchase decision.



Advocacy Threats

- A professional accountant having the opportunity to manipulate information in a prospectus in order to obtain favorable financing.



Familiarity Threats

- A professional accountant being responsible for the financial reporting of the employing organization when an immediate or close family member employed by the organization makes decisions that affect the financial reporting of the organization.
- A professional accountant having a long association with individuals influencing business decisions.



Intimidation Threats

- A professional accountant or immediate or close family member facing the threat of dismissal or replacement over a disagreement about:
  - The application of an accounting principle.
  - The way in which financial information is to be reported.
- An individual attempting to influence the decision-making process of the professional accountant, for example with regard to the awarding of contracts or the application of an accounting principle.

Specific circumstances give rise to unique threats to compliance with one or more of the fundamental principles. Such unique threats cannot be categorized. In either professional or business

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relationships, a professional accountant in public practice should always be on the alert for such circumstances and threats.

B. Evaluation of Threats:

The conditions, policies and procedures described above might impact the evaluation of whether a threat to compliance with the fundamental principles is at an acceptable level.

(i) **Acceptable level:** An acceptable level is a level at which a professional accountant using the reasonable and informed third party test would likely conclude that the accountant complies with the fundamental principles.

(ii) **Reasonable and Informed Third Party:** The reasonable and informed third party test is a consideration by the professional accountant about whether the same conclusions would likely be reached by another party. Such consideration is made from the perspective of a reasonable and informed third party, who weighs all the relevant facts and circumstances that the accountant knows, or could reasonably be expected to know, at the time the conclusions are made. The reasonable and informed third party does not need to be an accountant but would possess the relevant knowledge and experience to understand and evaluate the appropriateness of the accountant's conclusions in an impartial manner.

C. Addressing Threats

If the professional accountant determines that the identified threats to compliance with the fundamental principles are not at an acceptable level, the accountant shall address the threats by eliminating them or reducing them to an acceptable level. The accountant shall do so by:

(i) Eliminating the circumstances, including interests or relationships, that are creating the threats;

(ii) Applying safeguards, where available and capable of being applied, to reduce the threats to an acceptable level; or

(iii) Declining or ending the specific professional activity.

Actions to Eliminate Threats: Depending on the facts and circumstances, a threat might be addressed by eliminating the circumstance creating the threat. However, there are some situations in which threats can only be addressed by declining or ending the specific professional activity. This is because the circumstances that created the threats cannot be eliminated and safeguards are not capable of being applied to reduce the threat to an acceptable level.

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D. Safeguards:

Safeguards are actions individually or in combination that the accountant takes that effectively reduce threats to an acceptable level. Safeguards vary depending on the facts and circumstances. **Examples of actions that in certain circumstances might be safeguards to address threats include:**



- Assigning additional time and qualified personnel to required tasks when an engagement has been accepted might address a self-interest threat.
- Having an appropriate reviewer, who was not a member of the team, review the work performed or advise as necessary might address a self-review threat.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client might address self-review, advocacy or familiarity threats.
- Involving another firm to perform or re-perform part of the engagement might address self-interest, self-review, advocacy, familiarity or intimidation threats.
- Separating teams when dealing with matters of a confidential nature might address a self-interest threat.

2.3 Non-Compliance with Laws and Regulations (NOCLAR)

In the course of providing a professional service to a client or carrying out professional activities for an employer, a Professional accountant may come across an instance of non-compliance with laws and regulations (NOCLAR) or suspected NOCLAR committed or about to be committed **by the client or the employer**, or by those charged with governance, management or employees of the client or employer.

Non-compliance with laws and regulations ("non-compliance") comprises of acts of omission or commission, intentional or unintentional, which are contrary to the prevailing laws or regulations committed by:

- ☐ a client/professional accountant's employing organisation;
- ☐ those charged with governance of a client or employing organisation;
- ☐ management of a client/ employing organisation; or
- ☐ other individuals working for or under the direction of a client/ employing organisation.

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However, NOCLAR under Revised Code of Ethics does not address the personal misconduct unrelated to the business activities of the client/ employing organisation and non-compliance by parties other than listed out in the definition of NOCLAR.

As per IESBA, following examples would be covered in NOCLAR:-

Fraud, corruption and bribery	Money laundering, terrorist financing and proceeds of crime	Securities markets and trading	Banking and other financial products and services
Data protection	Environmental protection	Public health and safety	Tax and pension liabilities and payments

The objective of NOCLAR is that - turning a blind eye to potential NOCLAR is not an appropriate response from professional accountants, while placing renewed emphasis on the roles of management and those charged with governance in addressing the matter. Further, it increases awareness and understanding among Professional accountant of their legal and regulatory responsibilities when they face NOCLAR.

Some important facts about NOCLAR are given below:

During Course of Providing a Service: NOCLAR will be applicable if a professional accountant encounters, or is made aware of, non-compliance or suspected non-compliance in the course of providing a professional service to a client. He is not required to investigate, nor responsible for ensuring compete compliance.

Expertise of Laws not Required: A professional accountant is expected to apply knowledge and expertise, and exercise professional judgment. However, he is not expected to have a level of knowledge of laws and regulations greater than that which is required to undertake the engagement. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body.

Certain Matters Expressly out of Purview: Matters that are clearly inconsequential, or relating to personal misconduct pertaining to business activities of the client not covered.

Disclosure, which is Contrary to Law not Required: As per IESBA Code, disclosure of the matter to an appropriate authority would be precluded if doing so would be contrary to law or regulation.

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2.3.1 Applicability of NOCLAR in India:

1. **Responding to Non-Compliance with Laws and Regulations (NOCLAR) applicable to Professional Accountants in service (Section 260):** Applicable to Senior Professional Accountants in service, being employees of listed entities.

   Senior professional accountants in service ("senior professional accountants") are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and intangible resources.

   It is further explained that the senior professional accountants refer to key managerial personnel.

2. **Responding to Non-Compliance with Laws and Regulations (NOCLAR) applicable to Professional Accountants in public practice (Section 360) :** Applicable to Audit engagements of entities the shares of which are listed on recognized stock exchange(s) in India and have net worth of 250 crores of rupees or more.

   "For the purpose of Section-360 "Audit" or "Audit engagement" shall mean a reasonable assurance engagement in which a professional accountant in public practice expresses an opinion whether financial statements give a true and fair view in accordance with an applicable financial reporting framework".

2.3.2 NOCLAR vs. SA 250

1. SA 250 is applicable only on Audit, and not on other Assurance engagements. However, NOCLAR is applicable on professional accountants in service, and in practice.

2. SA 250 talks of auditor's responsibilities for laws having direct effect on the determination of material amounts and disclosures in the financial statements (such as tax and labour laws); and other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business. NOCLAR, while being alike to SA 250 till this point, is further ahead of it in that it takes into account non-compliance that causes substantial harm resulting in **serious consequences in financial or non-financial terms.**

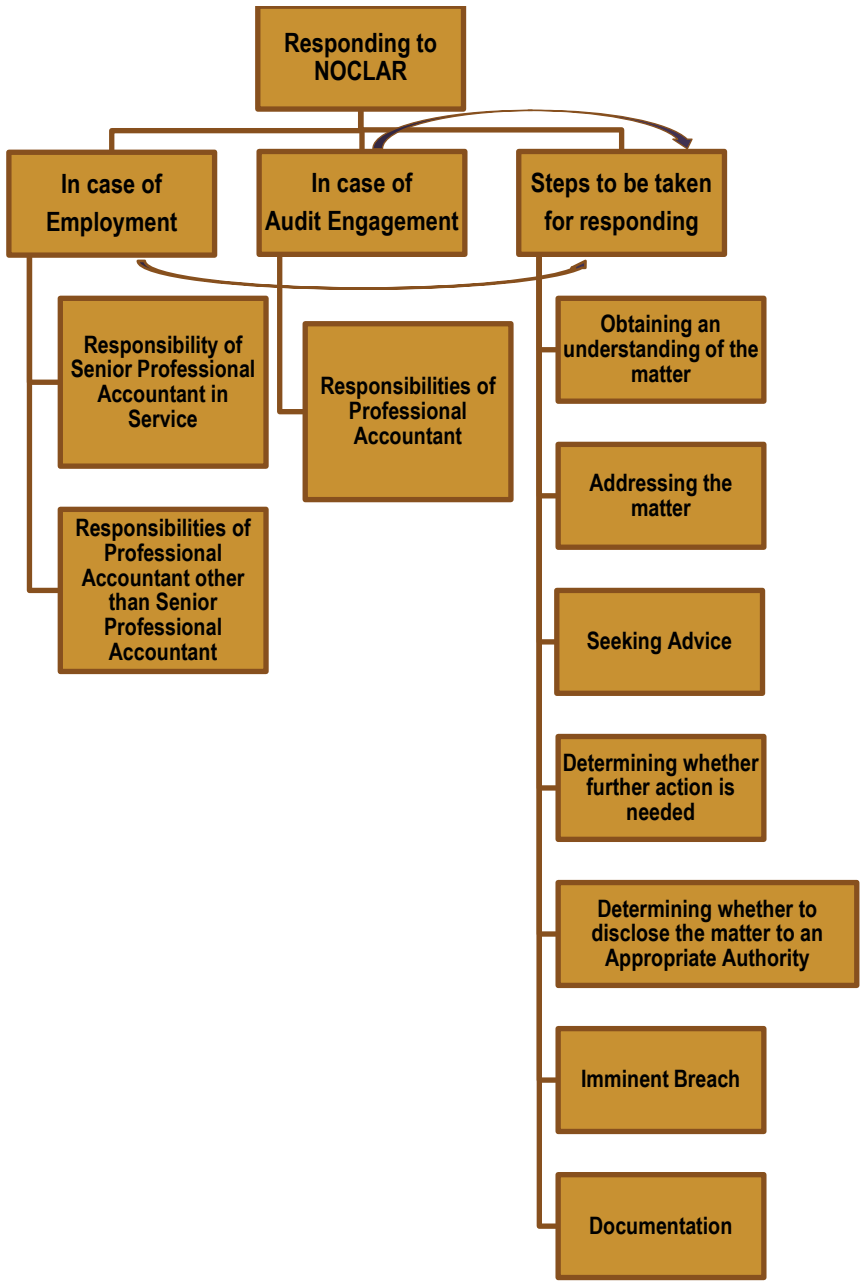
3. SA 250 does not define stakeholders. NOCLAR is related to affect of non-compliance on investors, creditors, employees as also the general public.

4. As per NOCLAR, in exceptional circumstances, the professional accountant might become aware of an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having first considered whether it would be appropriate to discuss the matter with management or those charged with governance of

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the company, the accountant shall exercise professional judgment and determine whether to disclose the matter immediately to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach. If disclosure is made, that disclosure is permitted. This provision is not existent in SA 250.

2.3.2 Responding to NOCLAR:



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It may also be noted that in a situation where disclosure ought to be made by the Auditor, the "Appropriate authority" for the purpose of disclosure will depend on the nature of the matter. For example, the appropriate authority would be SEBI in the case of fraudulent financial reporting.

Appropriate alignment has been made in the Code with regard to requirements of Confidentiality, as required under Chartered Accountants Act, 1949.

2.3.3 Provisions of Confidentiality under Chartered Accountants Act, 1949

For Members in practice – Clause (1) of Part -I of Second schedule to The Chartered Accountants Act, 1949 : A chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his client so engaging him, without the consent of his client or otherwise than as required by any law for the time being in force;

For Members in service - Clause (2) of Part-II to the Second Schedule of the Chartered Accountants Act, 1949 : A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer;

Documentation Requirements in NOCLAR :

Revised Code over and above require the professional accountant to follow the additional documents requirements as under:

- How management / those charged with governance have responded to the matter.
- The course of action the accountant considered, the judgments made and the decisions that were taken, having regard to the reasonable and informed third party test.
- How the accountant is satisfied that the responsibility of public interest has been fulfilled.

This documentation is in addition to complying with the documentation requirements under applicable auditing standards. SAs, for example, require a professional accountant performing an audit of financial statements to:

- Prepare documentation sufficient to enable an understanding of significant matters arising during the audit, the conclusions reached, and significant professional judgments made in reaching those conclusions;

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- Document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place; and
- Document identified or suspected non-compliance, and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.

3. MEMBERSHIP OF THE INSTITUTE

On acceptance of application by the Council, the applicant's name shall be entered in the Register and a certificate of membership in the appropriate Form shall be issued to the applicant.

Particulars of the Register: Section 19 of the Chartered Accountants Act, 1949 provides the particulars to be included in the Register about every member of the Institute, namely-

Full name, date of birth, domicile, residential and professional address;	
Date of entry of name in the Register;	Qualifications;
Whether the member holds a COP; and	Any other prescribed particulars.

3.1 Disabilities for the Purpose of Membership

Section 8 of the Chartered Accountants Act, 1949 enumerates the circumstances under which a person is debarred from having his name entered in or borne on the Register of Members, as follows:

(i) If he has not attained the age of 21 years at the time of his application for the entry of his name in the Register of members; or

(ii) If he is of unsound mind and stands so adjudged by a competent court; or

(iii) If he is an undischarged insolvent; or

(iv) If he, being a discharged insolvent, or has not obtained from the court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part; or

(v) If he has been convicted by a competent Court whether within or without India, of an offence involving moral turpitude and punishable with imprisonment or of an offence, not of a technical nature, committed by him in his professional capacity unless in respect of the offence committed he has either been granted a pardon or, on an application made by him in this behalf, the Central Government has, by an order in writing, removed the disability; or

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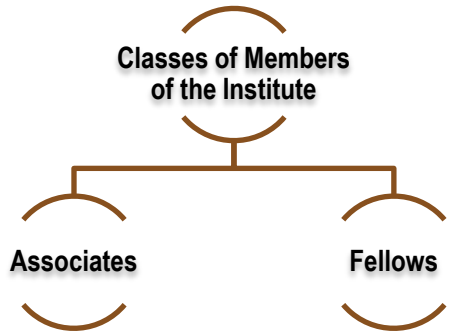
(vi) If he has been removed from membership of the Institute on being found on inquiry to have been guilty of professional or other misconduct;

It may be noted that a person who has been removed from membership for a specified period, shall not be entitled to have his name entered in the Register until the expiry of such period.

In addition, failure on the part of a person to disclose the fact that he suffers from any one of the disabilities aforementioned would constitute professional misconduct. The name of the person, who is found to have been subject at any time to any of the disabilities aforementioned, can be removed from the Register of Members by the Council.

3.2 Types of Members of the Institute

Section 5 of the Chartered Accountants Act, 1949 provides the division of members of the Institute. The members shall be divided into two classes designated as Associates and Fellows.



Associate Member: Any person, whose name has been entered in the Register of members, shall be deemed to have become an Associate of the Institute and shall also be entitled to use the letters A.C.A. after his name to indicate that he is an Associate Member of the Institute.

Fellow Member: The name of following types of members shall be entered into the Register of members as a Fellow of the Institute, on payment of such fees along with the application made and granted in the prescribed manner-

(i) An associate member who has been in continuous practice in India for at least 5 years,

(ii) A member who has been an associate for a continuous period of not less than 5 years and who possesses such qualifications as may be prescribed by the Council with a view to ensuring that he has experience equivalent to the experience normally acquired as a result of continuous practice for a period of 5 years as a Chartered Accountant.

The abovementioned members shall be entitled to use the letters F.C.A. after his name to indicate that he is a Fellow Member of the Institute.

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3.3 Removal of Name from the Register

As per section 20 of the Act, the Council may remove, from the Register, the name of any member of the Institute in the following cases-

(i) who is dead; or

(ii) from whom a request has been received to that effect; or

(iii) who has not paid any prescribed fee required to be paid by him; or

(iv) who is found to have been subject at the time when his name was entered in the Register of members, or who at any time thereafter has become subject, to any of the disabilities mentioned in Section 8, or who for any other reason has ceased to be entitled to have his name borne on the Register.

The Council shall remove the name of any member from the Register in respect of whom an order has been passed under this Act removing him from membership of the Institute.

If the name of any member has been removed from the Register for non-payment of prescribed fee as required to be paid by him, then, on receipt of an application, his name may be entered again in the Register of members on payment of the arrears of annual fee and entrance fee along with such additional fee, as may be determined by the Council.

3.4 Restoration of Membership

In addition to the provisions of the section 20 of the Chartered Accountants Act, 1949 (as discussed in above Para), Regulation 19 of the Chartered Accountants Regulations, 1988, states that the name of the member may be restored by the Council in the Register on an application, in the appropriate Form, received in this behalf whose name has been removed from the Register for non-payment of prescribed fee as required to be paid by him, if he is otherwise eligible to such membership, on his paying the arrears of annual membership fee, entrance fee and additional fee determined by the Council under the Act.

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However, the effective date in case of restoration of cancelled membership, in different situations, shall be in the following manner:

Application for restoration and requisite fees are made within the same year of removal	• Restoration shall be with effect from the date on which it was removed from the Register.
Removal of name under the orders of the Board of Discipline or the Disciplinary Committee or the Appellate Authority or the High Court	• Restoration shall be in accordance with such orders.
In other cases	• Restoration shall be with effect from the date on which the application and fee are received.

3.5 Penalty for Falsely Claiming to be a Member etc.

Section 24 of the Chartered Accountants Act, 1949 provides that any person who-

(i) not being a member of the Institute;

(a) represents that he is a member of the Institute; or

(b) uses the designation Chartered Accountant;

(ii) being a member of the Institute, but not having a certificate of practice, represents that he is in practice or practices as a Chartered Accountant,

shall be punishable on first conviction with fine which may extend to ₹ 1000, and on any subsequent conviction with imprisonment which may extend to 6 months or with fine which may extend to ₹ 5,000, or with both.

The provision may be understood with a case, where, the Court of Additional Chief Judicial Magistrate had by its judgement found the accused guilty under Section 24(i)(a) & (b) of the Chartered Accountants Act, 1949 and Section 465 of the Indian Penal Code. The Court imposed a fine on the accused and in the event of his failure to pay the fine, sentenced to rigorous imprisonment for three months. (Case of Prem Batra decided on 18.7.1989)

4. CHARTERED ACCOUNTANTS IN PRACTICE

A practicing Chartered Accountant is a person who is a member of the Institute and is holding Certificate of Practice; and includes such members of the Institute who are deemed to be in Practice in accordance with the provisions of the Chartered Accountants Act, 1949.

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4.1 Significance of the Certificate of Practice

Section 6 of the Chartered Accountants Act, 1949 provides that**: -**

(1) No member of the Institute shall be entitled to practise whether in India or elsewhere unless he has obtained from the Council a certificate of practice:

It may be noted that this provision is not applicable to any person who, immediately before the commencement of this Act, has been in practice as a registered accountant or a holder of a restricted certificate until one month has elapsed from the date of the first meeting of the Council.

(2) Every such member shall pay such annual fee for his certificate as may be determined, by notification, by the Council [..], and such fee shall be payable on or before the 1st day of April each year

(3) The certificate of practice obtained under sub-section (1) may be cancelled by the Council under such circumstances as may be prescribed.

A member who is not in practice is precluded from accepting engagement to render services of any of the types normally prescribed for a Chartered Accountant, even though for doing so, he does not require special qualifications.

The Council of the institute is of view that-

(i) Once the person concerned becomes a member of the Institute, he is bound by the provisions of the Chartered Accountants Act and its Regulations. If and when he appears before the Income-tax Tribunal as an Income-tax representative after having become a member of the Institute, he could so appear only in his capacity as a Chartered Accountant and a member of the Institute. Having, as it were, brought himself within the jurisdiction of the Chartered Accountants Act and its Regulations, he could not set them at naught by contending that even though he continues to be a member of the Institute and has been punished by suspension from practice as a member, he would be entitled, in substance, to practice in some other capacity.

(ii) A member of the Institute can have no other capacity in which he can take up such practice, separable from his capacity to practice as a member of the Institute."

Therefore, in nutshell, **a Chartered Accountant whose name has been removed from the membership for professional and/or other misconduct, during such period of removal, will not appear before the various tax authorities or other bodies before whom he could have appeared in his capacity as a member of this Institute.**

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Illustration 1

A Chartered Accountant in practice has been suspended from practice for a period of 6 months and he had surrendered his Certificate of Practice for the said period. During the said period of suspension, though the member did not undertake any audit assignments, he undertook representation assignments for income tax whereby he would appear before the tax authorities in his capacity as a Chartered Accountant.

Solution

Undertaking Tax Representation Work: A chartered accountant not holding certificate of practice cannot take up any other work because it would be violation of the relevant provisions of the Chartered Accountants Act, 1949.

In case a member is suspended and is not holding Certificate of Practice, he cannot in any other capacity take up any practice separable from his capacity to practice as a member of the Institute. This is because once a person becomes a member of the Institute; he is bound by the provisions of the Chartered Accountants Act, 1949 and its Regulations.

If he appears before the income tax authorities, he is only doing so in his capacity as a chartered accountant and a member of the Institute. Having bound himself by the said Act and its Regulations made there under, he cannot then set the Regulations at naught by contending that even though he continues to be a member and has been punished by suspension, he would be entitled to practice in some other capacity.

Conclusion: Thus, in the instant case, a chartered accountant would not be allowed to represent before the income tax authorities for the period he remains suspended. Accordingly, in the present case he is guilty of professional misconduct.

4.2 Cancellation and Restoration of Certificate of Practice

Regulation 10 provides that a Certificate of Practice (COP) shall be liable for cancellation, if:

(i)	the name of the holder of the certificate is removed from the Register; or
(ii)	the Council is satisfied, after giving an opportunity of being heard to the person concerned, that such certificate was issued on the basis of incorrect, misleading or false information, or by mistake or inadvertence; or
(iii)	a member has ceased to practise; or
(iv)	a member has not paid annual fee for certificate of practice till 30th day of September of the relevant year.

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Where a COP is cancelled, the holder shall surrender the same to the Secretary.

Further, Regulation 11 on restoration of COP states that, on an application made in the approved Form and on payment of such fee, the Council may restore the COP with effect from the date on which it was cancelled, to a member whose certificate has been cancelled due to non-payment of the annual fee for the COP and whose application, complete in all respects, together with the fee, is received by the Secretary before the expiry of the relevant year.

4.3 Members - deemed to be in Practice

Every member of the Institute is entitled to designate himself as a Chartered Accountant. There are two classes of members, those who are in practice and those who are otherwise occupied. In Section 2(2) of the Act, the term deemed "to be in practice" has been defined as follows:

"A member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, or in partnership with members of such other recognised professions as may be prescribed, he, in consideration of remuneration received or to be received.

(i)	engages himself in the practice of accountancy; or
(ii)	offers to perform or performs service involving the auditing or verification of financial transactions, books, accounts or records, or the preparation, verification or certification of financial accounting and related statements or holds himself out to the public as an accountant; or
(iii)	renders professional services or assistance in or about matters of principle or detail relating to accounting procedure or the recording, presentation or certification of financial facts or data; or
(iv)	renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice;

and the words "to be in practice" with their grammatical variations and cognate expressions shall be construed accordingly.

Explanation – An associate or a fellow of the Institute who is a salaried employee of a Chartered Accountant in practice or a firm of such Chartered Accountants or firm consisting of one or more chartered accountants and members of any other professional body having prescribed qualifications shall, notwithstanding such employment, be deemed to be in practice for the limited purpose of the training of Articled Assistants".

Pursuant to Section 2(2)(iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

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The expression "Management Consultancy and other Services" shall not include the function of statutory or periodical audit, tax (both direct taxes and indirect taxes) representation or advice concerning tax matters or acting as liquidator, trustee, executor, administrator, arbitrator or receiver, but shall include the following-

(i)	Financial management planning and financial policy determination.*
(ii)	Capital structure planning and advice regarding raising finance.*
(iii)	Working capital management.*
(iv)	Preparing project reports and feasibility studies.*
(v)	Preparing cash budget, cash flow statements, profitability statements, statements of sources and application of funds etc.
(vi)	Budgeting including capital budgets and revenue budgets.
(vii)	Inventory management, material handling and storage.
(viii)	Market research and demand studies.
(ix)	Price-fixation and other management decision making.
(x)	Management accounting systems, cost control and value analysis.
(xi)	Control methods and management information and reporting.
(xii)	Personnel recruitment and selection.
(xiii)	Setting up executive incentive plans, wage incentive plans etc.
(xiv)	Management and operational audits.
(xv)	Valuation of shares and business and advice regarding amalgamation, merger and acquisition. Acting as Registered Valuer under the Companies Act, 2013 read with The Companies (Registered Valuers and Valuation) Rules, 2017. (incorporated pursuant to decision of Council at its 388th Meeting)
(xvi)	Business Policy, corporate planning, organisation development, growth and diversification.
(xvii)	Organisation structure and behaviour, development of human resources including design and conduct of training programmes, work study, job-description, job evaluation and evaluation of workloads.
(xviii)	Systems analysis and design, and computer related services including selection of hardware and development of software in all areas of services which can otherwise be

* Consideration of "tax implications" while rendering the services at (i), (ii), (iii) and (iv) above will be considered as part of "Management Consultancy and other services".

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	rendered by a Chartered Accountant in practice and also to carry out any other professional services relating to EDP.
(xix)	Acting as advisor or consultant to an issue, including such matters as:
(a)	Drafting of prospectus and memorandum containing salient features of prospectus. Drafting and filing of listing agreement and completing formalities with Stock Exchanges, Registrar of Companies and SEBI.
(b)	Preparation of publicity budget, advice regarding arrangements for selection of (i) ad-media, (ii) centres for holding conferences of brokers, investors, etc., (iii) bankers to issue, (iv) collection centres, (v) brokers to issue, (vi) underwriters and the underwriting arrangement, distribution of publicity and issue material including application form, prospectus and brochure and deciding on the quantum of issue material (In doing so, the relevant provisions of the Code of Ethics must be kept in mind).
(c)	Advice regarding selection of various agencies connected with issue, namely Registrars to Issue, printers and advertising agencies.
(d)	Advice on the post issue activities, e.g., follow-up steps which include listing of instruments and dispatch of certificates and refunds, with the various agencies connected with the work. *Explanation* - For removal of doubts, it is hereby clarified that the activities of broking, underwriting and portfolio management are not permitted.
(xx)	Investment counselling in respect of securities [as defined in the Securities Contracts (Regulation) Act, 1956 and other financial instruments.] (In doing so, the relevant provisions of the Code of Ethics must be kept in mind).
(xxi)	Acting as registrar to an issue and for transfer of shares/other securities. (In doing so, the relevant provisions of the Code of Ethics must be kept in mind).
(xxii)	Quality Audit.
(xxiii)	Environment Audit.
(xxiv)	Energy Audit.
(xxv)	Acting as Recovery Consultant in the Banking Sector.
(xxvi)	Insurance Financial Advisory Services under the Insurance Regulatory & Development Authority Act, 1999, including Insurance Brokerage.
(xxvii)	Acting as Insolvency Professional in terms of Insolvency and Bankruptcy Code, 2016 (incorporated pursuant to decision of Council at its 362nd Meeting).
(xxviii)	Administrative Services. (incorporated pursuant to decision of Council at its 388th Meeting) Administrative services involve assisting clients with their routine or mechanical tasks within the normal course of operations. Such services require little to no professional judgment and are clerical in nature.

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Examples of administrative services include:



- Word processing services.
- Preparing administrative or statutory forms for client approval.
- Submitting such forms as instructed by the client.
- Monitoring statutory filing dates, and advising an audit client of those dates.



For example, the functions of a GST practitioner as specified under Rule 83(8) of Central Goods and Services Tax Rules, 2017:-

(a) furnish the details of outward and inward supplies;

(b) furnish monthly, quarterly, annual or final return;

(c) make deposit for credit into the electronic cash ledger;

(d) file a claim for refund;

(e) file an application for amendment or cancellation of registration;

(f) furnish information for generation of e-way bill;

(g) furnish details of challan in form GST ITC-04;

(h) file an application for amendment or cancellation of enrolment under rule 58; and

(i) file an intimation to pay tax under the composition scheme or withdraw from the said scheme.

Pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949, read with Regulation 191 of the Chartered Accountants Regulations, 1988 a member shall be deemed to be in practice if he, in his professional capacity and neither in his personal capacity nor in his capacity as an employee, acts as a liquidator, trustee, executor, administrator, arbitrator, receiver, adviser or representative for costing, financial or taxation matters or takes up an appointment made by the Central Government or a State Government or a court of law or any other legal authority or acts as a Secretary unless his employment is on a salary-cum-full-time basis.

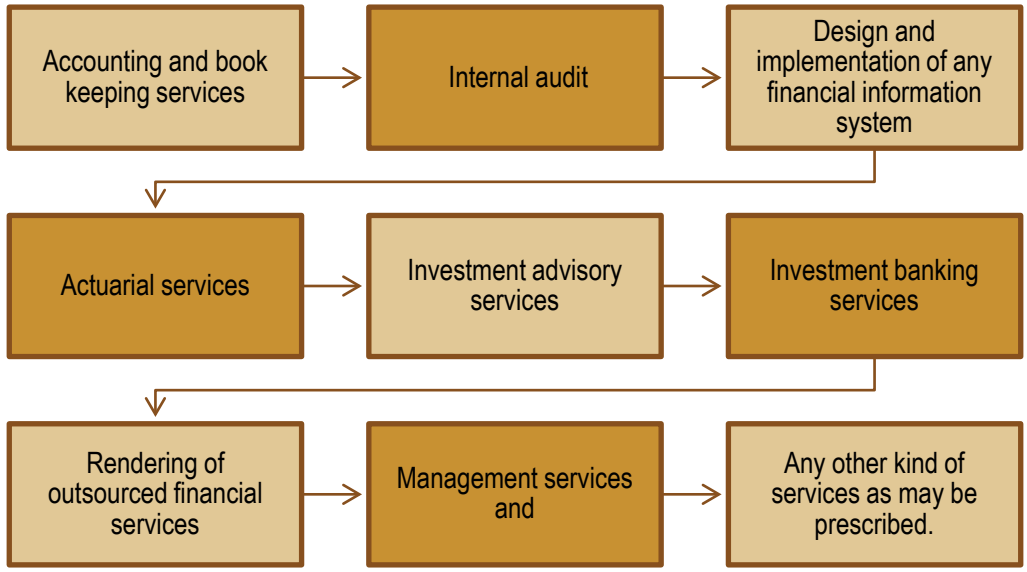
It is necessary to note that a person is deemed to be in practice not only when he is actually engaged in the practice of accountancy but also when he offers to render accounting services whether or not he in fact does so. In other words, the act of setting up of an establishment offering to perform accounting services would tantamount to being in practice even though no client has been served.

It may also be noted that a member of the Institute is deemed to be in practice during the period he renders 'service with armed forces'.

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The above provisions need to be correlated with the provisions of section 144 of the Companies Act, 2013 which prohibits an auditor of the company from rendering certain services directly or indirectly to the company or its holding company or its subsidiary company.

Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely (i) accounting and book- keeping services; (ii) internal audit; (iii) design and implementation of any financial information system; (iv) actuarial services; (v) investment advisory services; (vi) investment banking services; (vii) rendering of outsourced financial services;(viii) management services; and (ix) any other kind of services as may be prescribed.



Certain services not to be rendered by the Auditor as per section 144 of the Companies Act 2013.

Illustration 2

Mr. A, a practicing Chartered Accountant agreed to select and recruit personnel, conduct training programmes for and on behalf of a client where he is not providing any assurance service. Is this a professional misconduct?

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Solution

Providing Management Consultancy and Other Services: Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2)(iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

The definition of the expression "Management Consultancy and other Services" includes Personnel recruitment and selection. Personnel Recruitment and selection includes development of human resources including designing and conduct of training programmes, work study, job description, job evaluation and evaluations of workloads.

Conclusion: Therefore, Mr. A is not guilty of professional misconduct.

4.4 Companies not to Engage in Accountancy

Section 25 of the Chartered Accountants Act, 1949 provides that:

(1) No company, whether incorporated in India or elsewhere, shall practise as chartered accountants.

Here, the term "company" shall include any limited liability partnership which has company as its partner for the purpose of this section.

(2) If any company contravenes this provision then, without prejudice to any other proceedings which may be taken against the company, every director, manager, secretary and any other officer thereof who is knowingly a party to such contravention shall be punishable with fine which may extend on first conviction to ₹ 1,000 and on any subsequent conviction to ₹ 5,000.

In addition, as per section 141(2) of the Companies Act, 2013, where a firm (including a limited liability partnership) is appointed as an auditor of a company, then, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

Though the LLPs are allowed to be appointed as an auditor in accordance with the Companies Act, 2013, however, it cannot be engaged into practice, if it has company as its partner, as per the Chartered Accountants Act, 1949.

Therefore, it can be inferred that the LLP not having any company as its partner, can be engaged into practicing and thus take audit assignments.

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4.5 Member in Practice Prohibited from using a Designation other than Chartered Accountant

(i) Members of the Institute are now permitted to use the word 'CA' as prefix before their name irrespective of the fact that they are in practice or not.

(ii) Under Section 7 of the Chartered Accountants Act, 1949 a member in practice cannot use any designation other than that of a Chartered Accountant, nor he can use any other description, whether in addition thereto or in substitution therefor, but a member who is not in practice and does not use the designation of a Chartered Accountant may use any other description. Nevertheless a member in practice may use any other letters or description indicating *shall be deemed to prohibit any such person from adding any other description or letters to his name, if entitled thereto, to membership of such other Institute of accountancy, whether in India or elsewhere, as may be recognised in this behalf by the Council, or any other qualification that he may possess, or to prohibit a firm, all the partners of which are members of the Institute and in practice, from being known by its firm name as Chartered Accountants.*

Merchant Banker / Advisor to an issue: The members may apply for and obtain registration as category IV Merchant Banker under the SEBI's rules and regulations and act as Advisor or Consultant to an issue. In client Companies' offer documents and advertisements regarding capital issue, name and address of the Chartered Accountant or firm of Chartered Accountants acting as Advisor or Consultant to the Issue could be indicated under the caption "Advisor/Consultant to the Issue". However, the name and address of such Chartered Accountant/firm of Chartered Accountants should not appear prominently.

Directors of Companies, Members of political parties, position in clubs, etc.: The members of the Institute who are also Directors in Companies, members of Political parties or Chartered Accountants Cells in the political parties, holding different positions in clubs or other organisations are not permitted to mention these positions as these would be violative of the provisions of Section 7 of the Act.

Members who are also Cost Accountants: Though a member cannot designate himself as a Cost Accountant, he can use the letters A.C.M.A (Associate) or F.C.M.A (Fellow) after his name, when he is a member of that Institute.

Permission to mention qualifications of certain Institutions: The members are permitted to mention membership of a foreign Institute of Accountancy, which has been recognized by the Council through a Memorandum of Understanding (MoU) / Mutual Recognition Agreement (MRA) with the said Institute.

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Other Qualifications of the member

With regard to the other qualifications of a member, which he is permitted to mention, the following observations of the Supreme Court in Institute of Chartered Financial Analyst of India (ICFAI) vs Council of the Institute of Chartered Accountants of India (ICAI) dated 16th May, 2007 are relevant:

"The expression 'any other qualification that he may possess', therefore, must be read as qualification other than conferred upon the member by other Institutes of Accountancy. Such qualification of accountancy may be conferred even by other Institutes. But as noticed hereinbefore, an exemption had been granted by reason of a resolution of the Institute in relation to the Institute of Cost and Works Accountants. Furthermore, a degree conferred by any university also is subject to an exemption from the rigour of the provisions of Section 7 of the Act. There cannot, therefore, be any doubt whatsoever that 'the other qualification' would mean a qualification other than granted by an Institute of Accountancy, subject of course to recognition thereof by the Institute."



3. For example, though a member cannot designate himself as a Cost Accountant, he can use the letters A.C.M.A.(Associate) or F.C.M.A. (fellow) after his name, when he is a member of that Institute.

It is improper for a Chartered Accountant to state on his professional documents that he is an Income-tax Consultant, Cost Accountant, Company Secretary, Cost Consultant or a Management Consultant.

Member are allowed to appear before the various authorities including Company Law Board, Income Tax Appellate Tribunal, Sales Tax Tribunal where the law has permitted the same, so far as the designation "Corporate Lawyer" is concerned, the Council was of the view that as per the existing provisions of law, a Chartered Accountant in practice is not entitled to use the designation "Corporate Lawyer".

Further, the members are not permitted to use the initials 'CPA' (standing for Certified Public Accountant) on their visiting cards.

Members of the Institute in practice who are otherwise eligible may also practice as Company Secretaries and/or Cost Accountants. Such members shall, however, not use designation/s of the aforesaid Institute/s simultaneously with the designation "Chartered Accountant".

4.6 Maintenance of Branch Offices

In terms of Section 27 of the Act, if a Chartered Accountant in practice or a Firm of Chartered Accountants has more than one office in India, each one of such offices should be in the separate charge of a member of the Institute. Failure on the part of a member or a firm to have a member in

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charge of its branch and a separate member in case of each of the branches, where there is more than one, would constitute professional misconduct.

However, exemption has been given to members practicing in hill areas subject to certain conditions. The conditions are:

(1)	Such members/firm be allowed to open temporary offices in a city in the plains for a limited period not exceeding 3 months in a year.
(2)	The regular office need not be closed during this period and all correspondence can continue to be made at the regular office.
(3)	The name board of the firm in the temporary office should not be displayed at times other than the period such office is permitted to function as above.
(4)	The temporary office should not be mentioned in the letterheads, visiting cards or any other documents as a place of business of the member/firm.
(5)	Before commencement of every winter it shall be obligatory on the member/firm to inform the Institute that he/it is opening the temporary office from a particular date and after the office is closed at the expiry of the period of permission, an intimation to that effect should also be sent to the office of the Institute by registered post.

Above conditions apply to any additional office situated at a place beyond 50 kms from the municipal limits in which any office is situated.

It is necessary to mention that the Chartered Accountant in-charge of the branch of another firm should be associated with him or with the firm either as a partner or as a paid assistant. If he is a paid assistant, he must be in whole time employment with him.

The requirement of Section 27 in regard to a member being in charge of an office of a Chartered Accountant in practice or a firm of such Chartered Accountants shall be satisfied only if the member is actively associated with such office. Such association shall be deemed to exist if the member resides in the place where the office is situated for a period of not less than 182 days in a year or if he attends the said office for a period of not less than 182 days in a year or in such other circumstances as, in the opinion of the Executive Committee, establish such active association.

However, a member can be in-charge of two offices if they are located in one and the same Accommodation. In this context some of the Council's decisions are as follows:

(1) With regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of Chartered Accountant, provided it is a name-plate or a name-board of an individual member and not of the firm.

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Illustration 3

Mr. X & Mr. Y, partners of a Chartered Accountant Firm, one in-charge of Head Office and another in-charge of Branch at a distance of 80 km. from the municipal limits, puts up a name-board of the firm in both premises and also in their respective residences.

Putting Name Board of the Firm at Residence: *The Council of the Institute has decided that with regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of chartered accountant, provided, it is a name-plate or board of an individual member and not of the firm.*

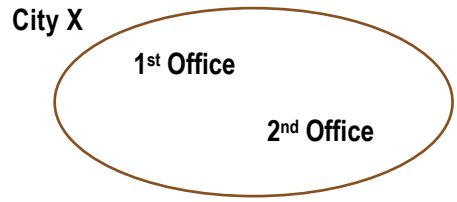
In the given case, partners of XY & Co. put up a name board of the firm in both offices and also in their respective residences.

Conclusion: Thus, the chartered accountants are guilty of misconduct. Distance given in the question is not relevant for deciding.

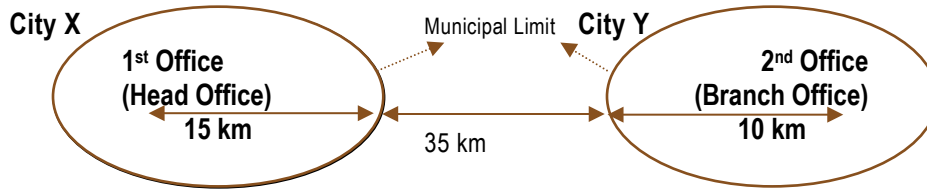
(2) The exemption may be granted to a member or a firm of Chartered Accountants in practice to have a second office without such second office being under the separate charge of a member of the Institute, provided-

(a) the second office is located in the same premises, in which the first office is located or,

(b) the second office is located in the same city, in which the first office is located or,



(c) the second office is located within a distance of 50 km. from the municipal limits of a city, in which the first office is located.



Effective distance from 1st Office = 35 km + 10 km = 45 km

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A member having two offices of the type referred to above shall have to declare, which of the two offices is his main office, which would constitute his professional address.

Illustration 4

Mr. K, Chartered Accountant practicing as a sole proprietor has an office in the suburbs of Chennai. Due to increase in the income tax assessment work, he opens another office near the income tax office, which is within the city and at a distance of 30 km. from his office in the suburb. For running the new office, he has employed a retired Income Tax Commissioner who is not a Chartered Accountant.

Solution

Maintenance of Branch Office in the Same City: As per section 27 of the Chartered Accountants Act, 1949 if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. However, a member can be in charge of two offices if the second office is located in the same premises or in the same city, in which the first office is located; or the second office is located within a distance of 50 km. from the municipal limits of a city, in which the first office is located.

In the given case, Mr. K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in suburbs of Chennai, and due to increase in the work he opened another branch within the city near the income tax office. He also employed a retired income tax commissioner to run the new office, and the second office is situated within a distance of 30 kilometers from his office in the suburb.

Conclusion: In view of the above provisions, there will be no misconduct if Mr. K will be in-charge of both the offices. However, he is bound to declare which of the two offices is the main office.

4.7 KYC Norms for CA in Practice

The financial services industry globally is required to obtain information of their clients and comply with Know Your Client Norms (KYC norms). Keeping in mind the highest standards of Chartered Accountancy profession in India, the Council of ICAI issued such norms to be observed by the members of the profession who are in practice.

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In light of this background, the Council of ICAI approved the following KYC Norms which are mandatory in nature and shall apply in all assignments pertaining to attestation functions.

The KYC Norms approved by the Council of ICAI are given below:

1. Where Client is an Individual/ Proprietor

A. General Information

- Name of the Individual
- PAN No. or Aadhar Card No. of the Individual
- Business Description
- Copy of last Audited Financial Statement

B. Engagement Information

- Type of Engagement

2. Where Client is a Corporate Entity

A. General Information

- Name and Address of the Entity
- Business Description
- Name of the Parent Company in case of Subsidiary
- Copy of last Audited Financial Statement

B. Engagement Information

- Type of Engagement

C. Regulatory Information

- Company PAN No.
- Company Identification No.
- Directors' Names & Addresses
- Directors' Identification No.

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3. Where Client is a Non-Corporate Entity

A. General Information

- Name and Address of the Entity
- Copy of PAN No.
- Business Description
- Partner's Names & Addresses (with their PAN/Aadhar Card/DIN No.)
- Copy of last Audited Financial Statement

B. Engagement Information

- Type of Engagement

5. CHARTERED ACCOUNTANTS IN SERVICE

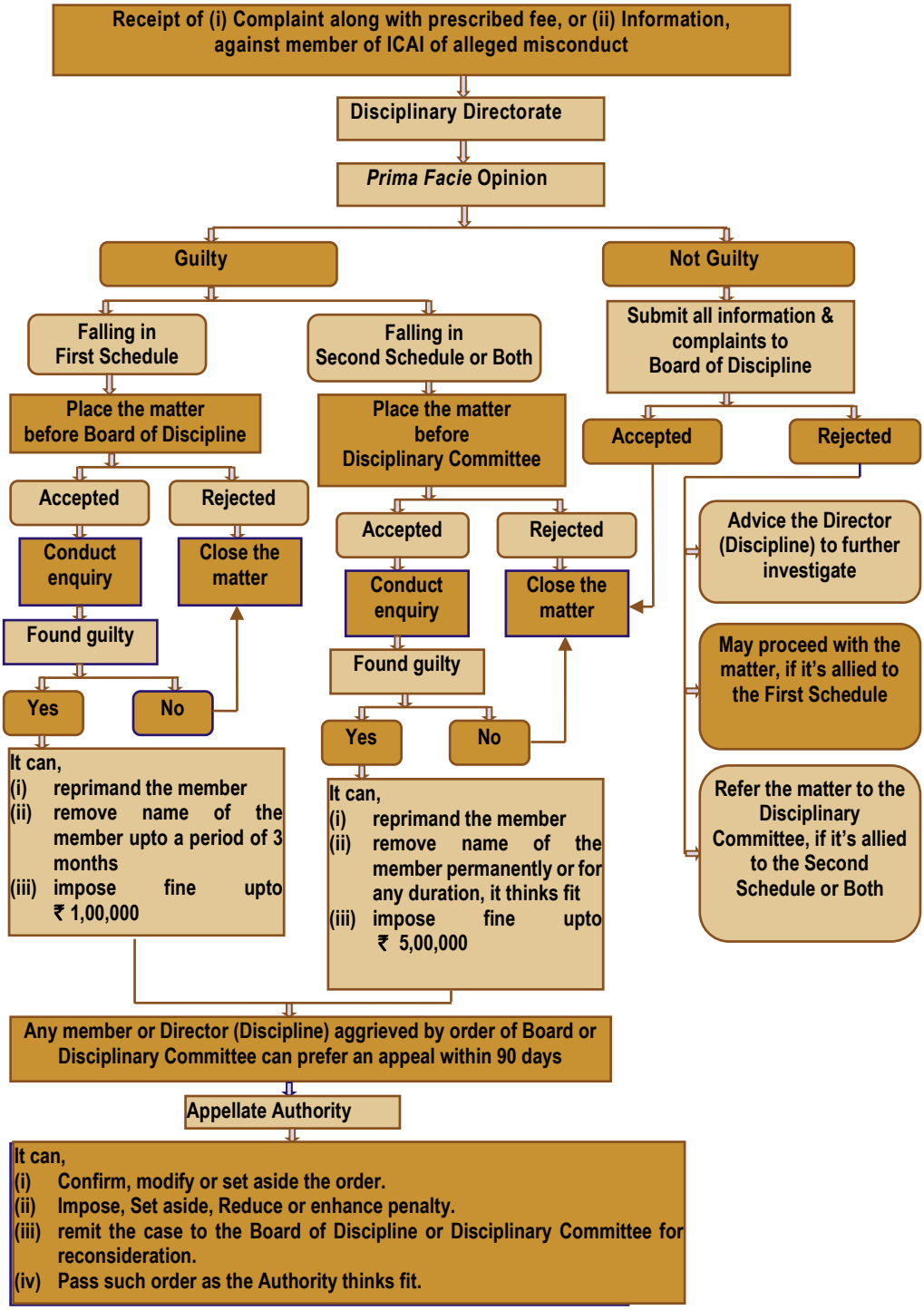
In accordance with the definitions provided under the Code of Ethics, a Professional Accountant in Service or Chartered Accountant in Service means a professional accountant employed or engaged in an executive or non-executive capacity in areas such as commerce, industry, service, the public sector, education, the not-for-profit sector, regulatory bodies or professional bodies, or a professional accountant contracted by such entities.

6 DISCIPLINARY PROCEDURE

Sections 21, 21A, 21B, 21C, 22-A and 22-G of the Chartered Accountants Act read with The Chartered Accountants (Procedure of Investigations of Professional and Other Misconduct of Cases) Rules, 2007 have laid down the following procedure in regard to the investigation of misconduct of members which has been summarized as under:-

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Flow Chart of Discipline Procedure Mechanism



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7 TYPES OF MISCONDUCT: PROFESSIONAL OR OTHER MISCONDUCT

For the purposes of this Act, the expression "professional or other misconduct" shall be deemed to include any act or omission, on the part of any member of the Institute either in his individual capacity or as partner or owner of a firm, as mentioned in any of the Schedules, but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Discipline) under sub-section (1) of section 21 to inquire into the conduct of such member or firm, under any other circumstances.'

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any Professional or Other Misconduct.

7.1 Professional Misconduct

Professional misconduct has been defined in part I, II and III of the First Schedule; and part I and II of the Second Schedule. A member who is engaged in the profession of accountancy whether in practice or in service should conduct/restrict his actions in accordance with the provisions contained in the respective parts of the schedules. If the member is found guilty of any of the acts or omissions stated in any of the respective parts of the Schedule, he/she shall be deemed to be guilty of professional misconduct.

7.2 Other Misconduct

Other misconduct has been defined in part IV of the First Schedule and part III of the Second Schedule. These provisions empower the Council to inquire into any misconduct of a member even it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action.



4. For example, a member who is found to have forged the will of a relative, would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty.

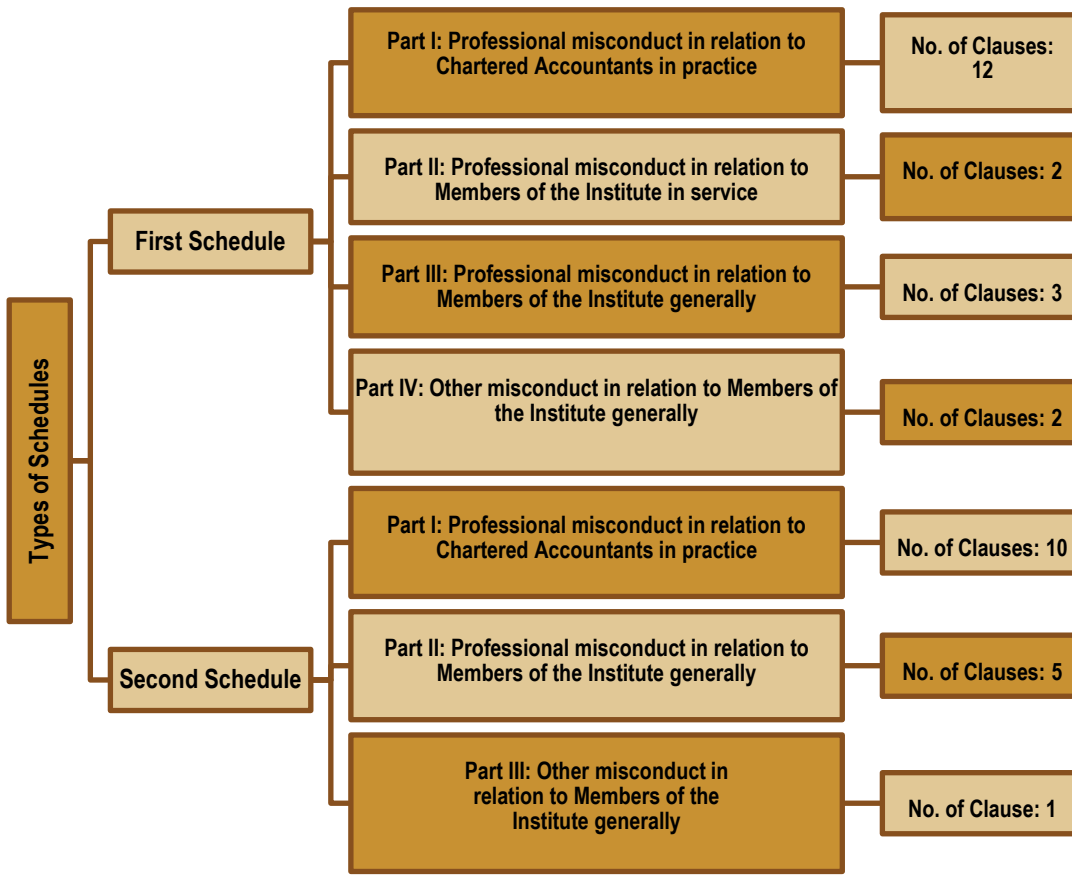
Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with transportation or imprisonment to an offence not of a technical nature committed by the member in his professional capacity. [See section 8(v) of the Act].

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8. SCHEDULES TO THE ACT

Acts or omissions which comprise professional misconduct within the meaning of Section 22 of the Chartered Accountants Act are defined in two Schedules viz. the First Schedule and the Second Schedule. The First Schedule is divided into four parts, Part I of the First Schedule deals with the misconduct of a member in practice which would have the effect generally of compromising his position as an independent person. Part II deals with misconduct of members in services. Part III deals with the misconduct of members generally and Part IV deals with other misconduct in relation to members of the institute generally.

The Second Schedule is divided into three parts. Part I deals with misconduct in relation to a member in practice, Part II deals with misconduct of members generally and Part III deals with other misconduct in relation to members of the Institute generally.



The implications of the different clauses in the schedules are discussed below:

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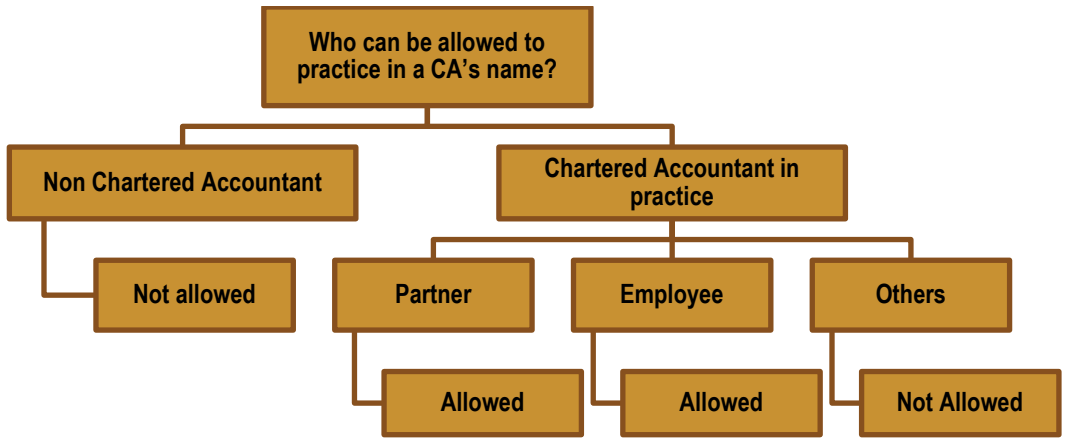
8.1 The First Schedule

Where the Director (Discipline) is of the opinion that member is guilty of any professional or other misconduct mentioned in the First Schedule; he shall place the matter before the Board of Discipline.

PART I - Professional Misconduct in relation to Chartered Accountants in Practice

A Chartered Accountant in practice is deemed to be guilty of professional misconduct if he:

Clause (1): allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him.



The above clause is intended to safeguard the public against unqualified accountant practicing under the cover of qualified accountants. It ensures that the work of the accountant will be carried out by a Chartered Accountant who may be his partner or his employee and would work under his control and supervision.

Illustration 5

C, Chartered Accountant, in practice allowed his brother-in-law Mr. P, who is not a Chartered Accountant, to practice in the name of CA C. He also allowed CA T, who is an employee in his firm to practice in the name. Whether CA C is correct in allowing his brother-in-law Mr. P and CA T employee of his firm to practice in his name.

Solution

Allowing to Practice in a Chartered Accountant's name: As per Clause (1) of Part I to the First Schedule to Chartered Accountants' Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he allows any person to practice in his name as a chartered

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accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him.

In the given situation CA C, Chartered Accountant who is in practice allowed a non-Chartered Accountant, his brother-in-law Mr. P to practice in the name of CA C is not correct in view of Clause 1 of Part I to the First Schedule. However, he can allow CA T who is an employee in his firm to practice in his name.

Conclusion: Thus, CA C will be held guilty of professional misconduct for allowing Mr. P who is not a Chartered Accountant to practice in his name as a chartered accountant as per Clause (1) of Part I to the First Schedule.

Clause (2): pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

Explanation - In this item, "partner" includes a person residing outside India with whom a chartered accountant in practice has entered into partnership which is not in contravention of item (4) of this Part.

It is in order for a member to share his fees or profits with another member of the Institute and/or a firm of Chartered Accountants. A practicing Member of the Institute can share fees or profits arising out of his professional business with such members of other professional bodies or with such other persons having such qualifications as may be prescribed from time to time by the Council.

The Council has prescribed [**Regulation 53A (1)** of the Chartered Accountants Regulations, 1988] the professional bodies, which are as under: -

(a) The Institute of Company Secretaries of India established under the Company Secretaries Act, 1980.

(b) The Institute of Cost & Works Accountants of India established under the Cost & Works Accountants Act, 1959.

(c) Bar Council of India established under the Advocates Act, 1961.

(d) The Indian Institute of Architects established under the Architects Act, 1972.

(e) The Institute of Actuaries of India established under the Actuaries Act, 2006.

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Further, the Council has also prescribed [Regulation 53A (3) of the Chartered Accountants Regulations, 1988] the persons qualified in India, which are as under:

(i) Company Secretary within the meaning of the Company Secretaries Act, 1980;

(ii) Cost Accountant within the meaning of the Cost and Works Accountants Act, 1959;

(iii) Actuary within the meaning of the Actuaries Act, 2006;

(iv) Bachelor in Engineering from a University established by law or an Institution recognised by law;

(v) Bachelor in Technology from a University established by law or an institution recognised by law;

(vi) Bachelor in Architecture from a University established by law or an institution recognised by law;

(vii) Bachelor in Law from a University established by law or an institution recognised by law;

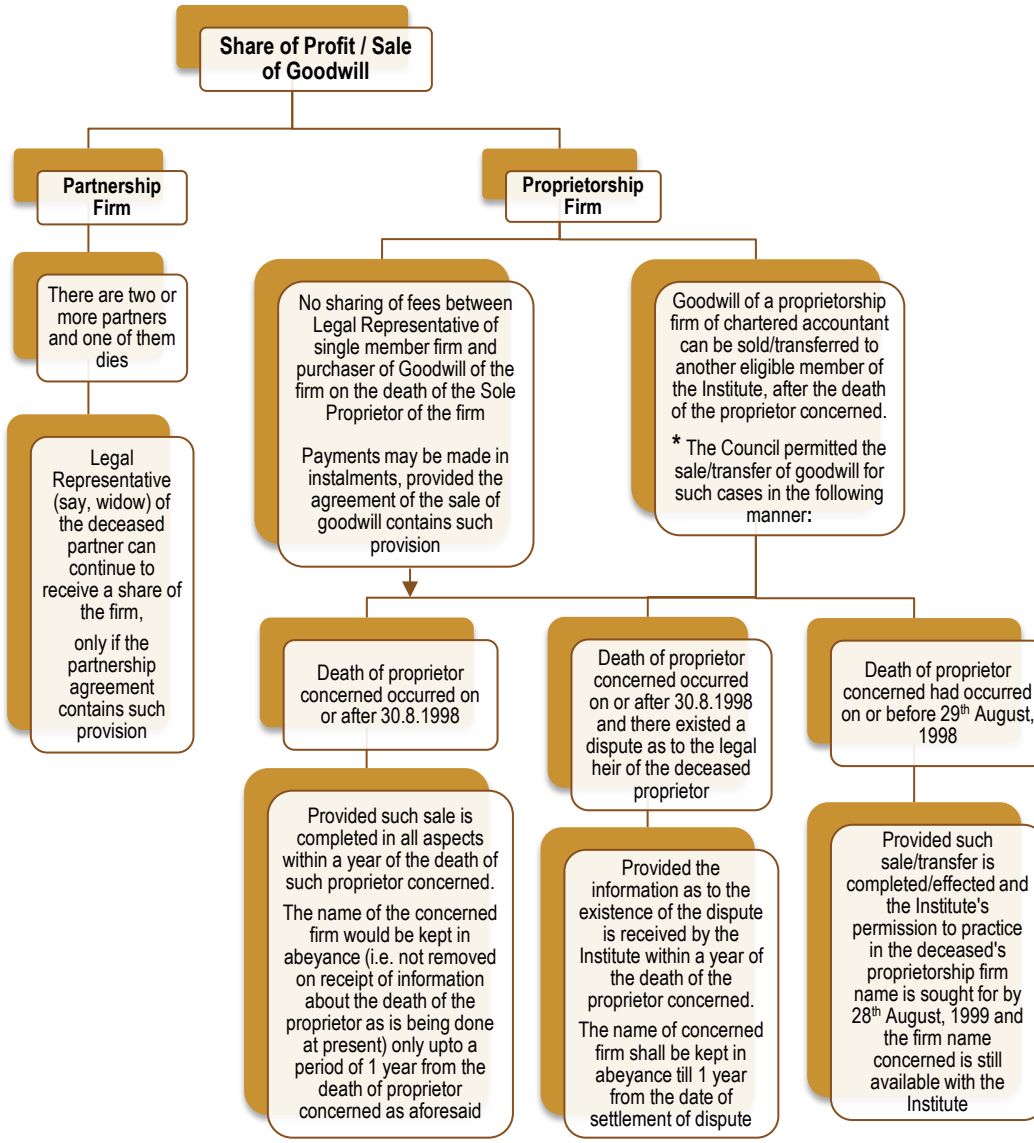
(viii) Master in Business Administration from Universities established by law or technical institutions recognised by All India Council for Technical Education.

The Institute came across certain Circulars/Orders issued by the Registrars of various State Co-operative Societies wherein it has been mentioned that certain amount of audit fee is payable to the concerned State Government and the auditor has to deposit a percentage of his audit fee in the state Treasury by a prescribed challan within a prescribed time of the receipt of Audit fee. The Council considered the issue and while noting that the Government is asking auditors to deposit such percentage of their audit fee for recovering the administrative and other expenses incurred in the process, the Council decided that as such there is no bar in the Code of Ethics to accept such assignment wherein a percentage of professional fee is deducted by the Government to meet the administrative and other expenditure.

Considering the case where a Chartered Accountant gave 50% of the audit fees received by him to the complainant, who was not a Chartered Accountant, under the nomenclature of office allowance and such an arrangement continued for a number of years, it was held by the Council that in substance the Chartered Accountant had shared his profits and, therefore, was guilty of professional misconduct under the clause. It is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

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Treatment of Goodwill –



* In case of a partnership firm when all the partners die at the same time, the above Council decision would also be applicable.

Illustration 6

Mr. Qureshi, Chartered Accountant, in practice died in a road accident. His widow proposes to sell the practice of her husband to Mr. Pardeshi, Chartered Accountant, for ₹ 5 lakhs. The price also includes right to use the firm name - Qureshi and Associates. Can widow of Qureshi sell the practice and can Mr. Pardeshi continue to practice in that name as a proprietor?

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Solution

Sale of Goodwill: With reference to Clause (2) of Part I to the First Schedule to Chartered Accountants' Act, 1949, the Council of the Institute of Chartered Accountants of India considered whether the goodwill of a proprietary concern of chartered accountant can be sold to another member who is otherwise eligible, after the death of the proprietor.

It lays down that the sale is permitted subject to certain conditions discussed in the above flowchart. It further resolved that the legal heir of the deceased member has to obtain the permission of the Council within a year of the death of the proprietor concerned.

Conclusion: Thus, in a given case, the widow of Mr. Qureshi, who has proposed to sell the practice for ₹ 5 lakhs is in effect proposing the sale of goodwill. Thus, the act of Mrs. Qureshi is permissible and Mr. Pardeshi can continue to practice in that name as a proprietor.

Clause (3): accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute.

Provided that nothing herein contained shall be construed as prohibiting a member 'from entering into profit sharing or other similar arrangements, including receiving any share commission or brokerage in the fees, with a member of such professional body or other person having qualifications, as is referred to in item (2) of this part.

Just as a member cannot share his fees with a non-member, he is also not permitted to receive and share the fees of others except for sharing with Member of such professional body or other person having such qualification as may be prescribed (Regulation 53A of the Chartered Accountants Regulations, 1988) by the Council for the purpose of Clause (2), (3) and (5) of Part I of First Schedule. Such a restriction is necessary so that a Chartered Accountant who is often required to engage or to recommend for engagement by his clients, the services of the members of other professions, cannot share the fees received by other persons who are otherwise not permitted by the Council in terms of provision of this clause.

Referral fees amongst members: It is not prohibited for a member in practice to charge Referral Fees, being the fees obtained by a member in practice from another member in practice in relation to referring a client to him.

Clause (4): enters into partnership, in or outside India, with any person other than Chartered Accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under clause (v) of sub-section (1) of section 4 or whose qualifications are recognized by the Central Government or the Council for the purpose of permitting such partnerships.

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The Council has prescribed Regulation 53A (3) (as discussed under clause (2) of this part) and Regulation 53B of the Chartered Accountants Regulations, 1988 for the persons qualified and the professional bodies.

The Regulation 53B prescribes the membership of following professional bodies for entering into partnership:

(a) Company Secretary, member, The Institute of Company Secretaries of India, established under the Company Secretaries Act, 1980;

(b) Cost Accountant, member, The Institute of Cost and Works Accountants of India established under the Cost and Works Accountants Act, 1959;

(c) Advocate, member, Bar Council of India established under the Advocates Act, 1961;

(d) Engineer, member, The Institution of Engineers, or Engineering from a University established by law or an institution recognized by law.

(e) Architect, member, The Indian Institute of Architects established under the Architects Act, 1972;

(f) Actuary, member, The Institute of Actuaries of India, established under the Actuaries Act, 2006.

A Chartered Accountant in practice is not permitted to enter into partnership with any person other than a Chartered Accountant in practice or such other persons as may be prescribed by the Council from time to time. The members may however take note of the fact that they cannot form Multi-Disciplinary partnerships till such time that Regulators of such other professionals also permit partnership with chartered accountants, and guidelines in this regard are issued by the Council.

Clause (5) secures either through the services of a person who is not an employee of such Chartered Accountant or who is not his partner or by means which are not open to a Chartered Accountant, any professional business.

Provided that nothing herein contained shall be construed as prohibiting any agreement permitted in terms of item (2), (3) and (4) of this part.

"A man must stand erect, and not to be kept erect by others", is a dictum by Marcus Aurelius which though applicable for a man in every walk of life is more so in the case of a professional life. A Chartered Accountant must seek work not through any agency, but by the respect, that he is able to command for his professional talent and skill and by the confidence he is able to inspire by his reputation. All forms of canvassing on that account are regarded unethical and are prohibited. The decision of the Council under this clause is given below:

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A Chartered Accountant wrote various letters to officers of different Army Canteens giving details about him and his experience, his partner & office and the norms for charging audit fees. He was held guilty for violation of Clauses (5) & (6). (Jethanand Sharda vs. Deepak Mehta – Council's decision dated 1st to 4th July, 1998 – Page 61 of Volume VIII(2) of Disciplinary Cases).

It may further be noted that the acts of partners and employees of the Firm towards securing professional work are subject to the provisions of Clauses (6) and (7) of Part-I of First Schedule of the Chartered Accountants Act, 1949.

Clause (6) solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Provided that nothing herein contained shall be construed as preventing or prohibiting -

(i) Any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice; or

(ii) A member from responding to tenders or enquiries issued by various users of professional services or organizations from time to time and securing professional work as a consequence.

However, as per the guideline issued by the Council of the Institute of Chartered Accountants of India, a member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for chartered accountants, such as audit and attestation services. However, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.

Further, keeping in view the broad purview of Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, an advertisement of Coaching /teaching activities by a member in practice may amount to indirect solicitation, as well as solicitation by any other means, and may therefore be violative of the provisions of Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

In view of the above, such members are advised to abstain from advertising their association with Coaching / teaching activities through hoardings, posters, banners and by any other means, failing which they may be liable for disciplinary action, as per the provisions of the Chartered Accountants Act, 1949 and Rules/Regulations framed thereunder. However, it may be noted that subject to the above prohibition, such members may put, outside their Coaching/teaching premises, sign board mentioning the name of Coaching/teaching Institute, contact details and subjects taught therein only.

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As regards the size and type of signboard, the Council Guidelines as applicable to Firms of Chartered Accountants would apply.

It is an elaboration of the principle propounded in the preceding clause enjoining that for securing professional work the help of others should not be sought. This clause further enjoins on a member not to solicit professional work by means of advertisement, circular, personal communication or interview or by any other means. The members should not adopt any indirect methods to adventure their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practiced so that members may maintain their independence of judgment and may be able to command the respect of their prospective clients.

The professional work cannot be secured either by advertisement or by circulars or by solicitation. It can only be obtained by a member gradually building confidence in his ability and integrity. The service tendered by an accountant is of a personal and intimate nature and its value can be appraised only by personal contact and experience. A public advertisement is likely to lead to an impression that the professional person is over anxious to win confidence, which however will have the opposite effect. The satisfaction of clients would be the best advertisement, which would lead to other clients. Unabashed advertisement would affect the public esteem in which the profession is held and would act to the disadvantage of its members. An advertisement is not a key to success in the profession. It is the quality service, which attracts and retains the clients.

Some forms of soliciting work which the Council has prohibited are discussed below:

(a) **Advertisement and note in the press –** Members should not advertise for soliciting work or advertise in a manner which could be interpreted as soliciting or offering to undertake professional work. They are also not permitted to use the less open method of circulating letters to a small field of possible clients. Personal canvassing or canvassing for clients of previous employer through the help of the employees are also not permitted. The **exceptions** to the above rule are:

(i) A member may request another Chartered Accountant in practice for professional work.

(ii) a member may advertise changes in partnerships or dissolution of a firm, or of any change in address of practice and telephone numbers. Such announcements should be limited to a bare statement of facts and consideration given to the appropriateness of the area of distribution of the newspaper or magazine and number of insertions.

(iii) a member is also permitted to issue a classified advertisement in the journal/ newsletter of the Institute intended to give information for sharing professional work

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on assignment basis or for seeking partnership or salaried employment of an accountancy nature, provided it only contains the accountant's name, address or telephone number, fax number, e-mail address and address(es) of social Networking sites of members. However, mere factual position of experience and area of specialization, relevant to seek response to the advertisement, are permissible.

(b) **Application for empanelment for allotment of audit and other professional work –** The Government departments, government companies/Corporations, courts, co-operative societies and banks and other similar institutions prepare panels of chartered accountants for allotment of audit and other professional work. Where the existence of such a panel is within the knowledge of a member, he is free to write to the concerned organization with a request to place his name on the panel. **However, it would not be proper for the Chartered Accountant to make roving enquiries by applying to any such organization for having his name included in any such panel.** It is permissible to quote fees on enquiries being received from such bodies, which maintain such panel.

(c) **Responding to Tenders, Advertisements and Circulars:** It is not prohibited to the members to respond to tenders and requests made by users of professional work. This is however subject to conditions that may be issued by the Council from time to time.

The Council has issued Guidelines No. 1-CA(7)/03/2016 dated 7th April 2016 (see **Appendix 'J')** which stipulate that a member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for Chartered Accountants, such as audit and attestation services. However, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants. *The "minimum fee" for this purpose should be such that it commensurates with size, value, volume, manpower requirement and nature of work*.

EMD/Security Deposit: The Council is of the view that while interference with the practices prevailing for requirement of EMD/Deposit is not required. However, on having received complaint/ instance of exorbitant EMD/Deposit, the Ethical Standards Board may look into the matter on case to case basis.

A cost sheet be maintained by members of the Institute responding to tenders, incorporating details of the costs being incurred therein having regard to number of persons involved, hours to be spent, etc, so that the same may be called for by the Institute for perusal.

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(d) **Publication of Books, Articles or Presentation:** It is not permissible for a member to mention in a book or an article published by him, or a presentation made by him, any professional attainment(s), whether of the member or the firm of chartered accountants, with which he is associated. However, he may indicate in a book, article or presentation the designation "Chartered Accountant" as well as the name of the firm.

(e) **Issue of Greeting Cards or Invitations:** The Council does not approve of the issue of greeting cards or personal invitations by members indicating their professional designation, status and qualifications etc. However, the Council is of the view that the designation "Chartered Accountant" as well as the name of the firm may be used in greeting cards, invitations for marriages and religious ceremonies and any invitations for opening or inauguration of office of the members, change in office premises and change in telephone numbers, provided that such greeting cards or invitations etc. are sent only to clients, relatives and friends of the members concerned.

(f) **Advertisement for Silver, Golden, Platinum or Centenary celebrations:** It is not permitted to advertise the events organised by a Firm of Chartered Accountants. However, considering the need of interpersonal socialization/relationship of the members through such get together occasions, the advertisement for Silver, Golden, Diamond, Platinum or Centenary celebrations of the Chartered Accountants Firms may be published in newspaper or newsletter.

(g) **Sponsoring Activities**

(a) A member in practice or a Firm of Chartered Accountants is not permitted to sponsor an event. However, such member or Firm may sponsor an event conducted by a Programme Organizing Unit (PoU) of the ICAI, provided such event has the prior approval of Continuing Professional Education (CPE) Directorate of the ICAI.

(b) Members sponsoring activities relating to Corporate Social Responsibility may mention their individual name with the prefix "CA". However, the mention of Firm name or CA Logo is not permitted.

(h) **Advertisement of Teaching/Coaching activities by members:** The members engaged in teaching /coaching activities, while advertising such teaching /coaching activities, shall comply with the Regulation 190A of the Chartered Accountants Regulations, 1988(discussed in the Chapter in Clause 11).

Keeping in view the broad purview of Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, an advertisement of Coaching /teaching activities by a

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member in practice may amount to indirect solicitation, as well as solicitation by any other means, and may therefore be violative of the provisions of Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

In view of the above, such members are advised to abstain from advertising their association with Coaching /teaching activities through hoardings, posters, banners and by any other means, failing which they may be liable for disciplinary action, as per the provisions of the Chartered Accountants Act, 1949 and Rules/Regulations framed thereunder.

Subject to the above prohibition, such members may put, outside their Coaching/ teaching premises, a sign board mentioning the name of Coaching/teaching Institute, contact details and subjects taught therein only. As regards the size and type of signboard, the Council Guidelines as applicable to Firms of Chartered Accountants would apply.

(i) **Sharing Firm Profile with prospective Client:** It is not permitted to share Firm profile with a prospective Client unless it is in response to a proposed client's specific query, and otherwise not prohibited to be used by the client.

(j) **Television or Movie Credits:** While sharing name of the member or Firm of Chartered Accountants for inclusion in Television or Movie Credits, it must be taken care of that exhibition of name is not made differently as compared to other entries in the credits.

(k) **Soliciting professional work by making roving enquiries:** It is not permissible for a member to address letters, emails or circulars specifically to persons who are likely to require services of a Chartered Accountant since it would tantamount to advertisement.

(l) **Seeking work from Professional Colleagues:** The issue of an advertisement or a circular by a Chartered Accountant, seeking work from professional colleagues on any basis whatsoever except as provided above would be in violation of this clause.

(m) **Scope of representation which an auditor is entitled to make under Section 225(3) of the Companies Act, 1956 (Section 140(4) of the Companies Act, 2013):** The right to make representation does not mean that an auditor has any prescriptive right or a lien to an audit. The wording of his representation should be such that, apart from the opportunity not being abused to secure needless publicity, it does not tantamount directly or indirectly to canvassing or soliciting for his continuance as an auditor. The letter should merely set out in a dignified manner how he has been acting independently and conscientiously through the term of office and may, in addition, indicate if he so chooses, his willingness to continue as auditor if reappointed by the shareholders.

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(n) **Acceptance of original professional work by a member emanating from the client introduced to him by another member:** The Council has decided that a member should not accept the original professional work emanating from a client introduced to him by another member. If any professional work of such client comes to him directly, it should be his duty to ask the client that he should come through the other member dealing generally with his original work.

(o) **Giving Public Interviews:** While giving any interview or otherwise furnishing details about themselves or their firms in public interviews or to the press or at any forum, the members should ensure that, it should not result in publicity. Due care should be taken to ensure that such interviews or details about the members or their firms are not given in a manner highlighting their professional attainments. Any detail which is given must, in addition to meeting the above requirements, be given only as a response to a specific question, and of factual nature only.

(p) **Members and/or firms who publish advertisements under Box numbers:** Members/Firms are prohibited from inserting advertisements for soliciting clients or professional work under box numbers in the newspapers. This practice is in violation of this clause.

(q) **Educational Videos**: While the videos of educational nature may be uploaded on the internet by members, no reference should be made to the Chartered Accountants Firm wherein the member is a partner/ proprietor. Further, it should not contain any contact details or website address.

Illustration 7

Mr. S, a Chartered Accountant published a book and gave his personal details as the author. These details also mentioned his professional experience.

Soliciting Professional Work: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 refers to professional misconduct of a member in practice if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means. Therefore, members should not adopt any indirect methods to advertise their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practiced so that members may maintain their independence of judgement and may be able to command the respect of their prospective clients. While elaborating forms of soliciting work, the Council has specified that a member is not permitted to indicate in a book or an article, published by him, his association with any firm of chartered accountants. In this case, Mr. S, a Chartered Accountant published the book and mentioned his professional experience in detail in the same.

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Conclusion: Mr. S being a chartered accountant in practice has committed the professional misconduct by mentioning his professional experience.

Illustration 8

M/s XYZ, a firm of Chartered Accountants created a website "www.xyzindia.com". The website besides containing details of the firm and bio-data of the partners also contains the passport size photographs of all the partners of the firm.

Hosting Details on Website: As per detailed guidelines of the ICAI laid down in Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant of the firm can create its own website using any format subject to guidelines. However, the website should be so designed that it does not solicit clients or professional work and should not amount to direct or indirect advertisement. The guidelines of the ICAI to allow a firm to put up the details of the firm, bio-data of partners and display of a passport size photograph.

Conclusion: In the case of M/s XYZ, all the guidelines seem to have been complied and there appears to be no violation of the Chartered Accountants Act, 1949 and its Regulations.

Illustration 9

M/s LMN, a firm of Chartered Accountants responded to a tender from a State Government for computerization of land revenue records. For this purpose, the firm also paid ₹ 50,000 as earnest deposit as part of the terms of the tender.

Responding to Tenders: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits. However, on having received complaint/ instance of exorbitant EMD/Deposit, the Ethical Standards Board may look into the matter on case to case basis.

Conclusion: In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s LMN can respond to tender as well as deposit ₹ 50,000 as earnest deposit and shall not have committed any professional misconduct.

Illustration 10

Mr. Honest, a Chartered Accountant in practice, wrote two letters to M/s XY Chartered Accountants a firm of CAs; requesting them to allot him some professional work. As he did not have a significant practice or clients he also wrote a letter to M/s ABC, a firm of Chartered Accountants for securing professional work. Mr. Clever, another CA, informed ICAI regarding Mr. Honest's approach to secure the professional work. Is Mr. Honest wrong in soliciting professional work?

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Securing Professional Work: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Provided that nothing herein contained shall be construed as preventing or prohibiting any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice.

Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

Conclusion: In the given case, Mr. Honest wrote letters only to other Chartered Accountants, M/s XY and M/s ABC requesting them to allot some professional work to him, which is not prohibited under Clause (6) as explained above. Thus, Mr. Honest has not committed any professional misconduct by soliciting professional work.

Clause (7) advertises his professional attainments or services, or uses any designation or expressions other than the Chartered Accountant on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a University established by law in India or recognized by the Central Government or a title indicating membership of the Institute of Chartered Accountants or of any other institution that has been recognized by the Central Government or may be recognized by the Council.

Provided that a member in practice may advertise through a write up, setting out the service provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council.

This clause prohibits advertising of professional attainments or services of a member. However, the services can be advertised in a restricted way through a write up subject to the Guidelines of the Council issued from time to time. Refer chapter 3 of the book. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public.

Other Designations: It is improper for a Chartered Accountant in practice to state on his professional documents that he is an Income-tax Consultant, Cost Accountant, Company Secretary, Cost Consultant or a Management Consultant.

While noting that it had already allowed its members to appear before the various authorities including Company Law Board, Income Tax Appellate Tribunal, Sales Tax Tribunal where the law

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has permitted the same, so far as the designation "Corporate Lawyer" is concerned, the Council was of the view that as per the existing provisions of law, a Chartered Accountant in practice is not entitled to use the designation "Corporate Lawyer".

A member must not use the designation such as 'Member of Parliament', 'Municipal Councilor' nor any other functionary in addition to that of Chartered Accountant.

A member empanelled as Insolvency Professional or Registered Valuer can mention "Insolvency Professional" or "Registered Valuer" respectively on his visiting card and letter head.

Permission to mention qualifications of certain Institutions: The members are permitted to mention a title on their visiting cards to indicate membership of a foreign Institute of Accountancy, which has been recognised by the Council e.g. South African Institute of Chartered Accountants (SAICA), Institute of Certified Public Accountants (CPA Ireland) and Institute of Chartered Accountants in England and Wales (ICAEW).

Date of setting-up practice: The date of setting up the practice by a member or the date of establishment of the firm on the letter heads and other professional documents etc. should not be mentioned.

Practice as Advocate: Members of the Institute in practice who are otherwise eligible may practise as advocates subject to the permission of the Bar Council but in such case, they should not use designation 'Chartered Accountant' in respect of the matters involving the practice as an advocate. In respect of other matters, they should use the designation 'Chartered Accountant' **but they should not use the designation 'Chartered Accountant' and 'Advocate' simultaneously.**

Practice as Company Secretary/Cost Management Accountant: Members of the Institute in practice who are otherwise eligible may also practice as Company Secretaries and/or Cost Management Accountants. Such members shall, however, not use designation/s of the aforesaid Institute/s simultaneously with the designation "Chartered Accountant".

It is clarified that in the event of the permission being granted to a member in practice to also hold COP of sister Institute(s)/Bar Council, such a member be treated as a member in full-time practice.

Mention of Firm name except on Professional Documents: It is not proper for a Firm of Chartered Accountants to use the designation 'Chartered Accountant' except on professional documents, visiting cards, letter heads or sign boards and under the circumstances clarified under Clause (6). However, an individual member may use the prefix "CA" with his name.

Notice in the Press relating to the Success in an Examination: Notice in the press relating to the success in an examination of an individual candidate, should not contain any element of

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undesirable publicity either in relation to the articled/audit assistant or an employee or the member or the firm with whom he was served.

It is usual for local papers to publish details of the examination success of local candidates. Some biographical information is often included. The rule aforementioned is not intended to discourage the printing of news of local interest but is intended to indicate the need for restraint. The candidate's name and address, school and local background, examination passed with details of any prize or place gained, the name of the principal, firm and town in which the principal practices may be published.

Reports and Certificates: The reports and certificates issued by a Chartered Accountant bring him to the notice of the public in a greater or lesser degree. It is therefore incumbent upon him to ensure that the extent and manner of publication of certificates are limited to what is necessary to enable the report or certificate to serve its proper purpose. The members may however note that they should use letterhead of their Firm for issuing reports and certificates.

Appearance of Chartered Accountants on Electronic Media (including Internet): Members may appear on television, films and Internet and agree to broadcast in the Radio or give lectures at forums and may give their names and describe themselves as Chartered Accountants. Special qualifications or specialised knowledge directly relevant to the subject matter of the programme may also be given. Firm name may also be mentioned, however, any exaggerated claim or any kind of comparison is not permissible. What he may say or write must not be promotional of him or his firm but must be an objective professional view of the topic under consideration.

Publicity is permitted for appointments to positions of local or national importance or for the views of members on matters of similar importance. Mention of the membership of the Institute is desirable in such cases. What should be aimed at is to achieve suitable publicity for the Institute and its members generally. Members giving talks or lectures or attending conference may describe themselves as Chartered Accountants only when they are acting in their capacity as Chartered Accountants. However, reference to the professional firm of the member should not be given.

Organising Training Courses, Seminars etc. for his staff: A Chartered Accountant in practice holding training courses, seminars etc. for his staff may also invite the staff of other Chartered Accountants and clients to attend the same. However, undue prominence should not be given to the name of the Chartered Accountant in any booklet or document issued in connection therewith.

Writing Articles or Letters to the Press: Members writing articles or letters to the Press on subjects connected with the profession may give their names and use the description Chartered Accountants.

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Size of Sign Board: With regard to the size of sign board for his office that a member can put up, it is a matter in which the members should exercise their own discretion and good taste while keeping in mind the appropriate visibility and illumination (limited to the sake of visibility). However, use of glow signs or lights on large-sized boards as is used by traders or shop-keepers is not permissible. A member can have a name board at the place of his residence with the designation of a Chartered Accountant, provided it is a name plate or name board of an individual member and not of the firm.

Public Announcements with details of Directors: The Council's attention has been drawn to the fact that more and more Companies are appointing Chartered Accountants as Directors on their Boards. The prospectus or public announcements issued by these Companies often publish descriptions about the Chartered Accountant's expertise, specialisation and knowledge in any particular field or add appellations or adjectives to their names. Attention of the members in this context is invited to the provisions of Clause (6) and (7) of Part I of the First Schedule to the Chartered Accountants Act.

In order that the inclusion of the name of a member of the Institute in the prospectus or public announcements or other public communications issued by the Companies in which the member is a director does not contravene the above noted provisions, it is necessary that the members should take necessary steps to ensure that such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the member. While it may be difficult to lay down a rigid rule in this respect, the members must use their good judgement, depending upon the facts and circumstances of each case to ensure that the above noted provisions are complied with both in letter and spirit.

It is advisable for a member that as soon as he is appointed as a director on the Board of a Company, he should specifically invite the attention of the management of the Company to the aforesaid provisions and should request that before any such prospectus or public announcements or public communication mentioning the name of the member concerned, is issued, the material pertaining to the member concerned should, as far as practicable be got approved by him. The use of the expression 'Chartered Accountant' is permissible. However, the member must ensure that descriptions about his expertise, specialisation and knowledge in any particular field or other appellations or adjectives are not published with his name. Particulars about directorships held by the member in other Companies can, however, be given, but the name of the firm of Chartered Accountants in which the member is a partner, should not be given.

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Network Firms and Networking Guidelines: ***The Council has permitted Network amongst the Firms registered with the Institute. A member of the Network may advertise to the extent permitted by the Advertisement Guidelines issued by Institute.***

Note:
Students are required to refer Para 9 of this Chapter for Guidelines for Networking discussed in Chapter XV of Council General Guidelines 2008.
Advertisement Guidelines issued by Institute are being given in details in the Chapter

Use of Logo: For use of logos by Members on letter heads, visiting cards etc. the Council had decided that the logos unconnected with the first letter of the name of the firm or its partners or proprietors would not be permitted for use by members in practice/firms of Chartered Accountants on their letter heads, visiting cards etc. as the same would have amounted to advertisement or smacking of publicity. Subsequent to above, the Institute came across cases of registration of firm name in circumvention of the provisions contained in the Regulation 190 of the Chartered Accountants Regulations, 1988. The members/firms by themselves or through engineered name had been seeking to obtain firm name approval based on the name of the partner/s selected in the manner that logo of the firm would be identical to the firm name which would have not otherwise been permissible as firm name under Regulation 190.

In order to ensure compliance with the Regulations, the Council decided that the use of logo/monogram of any kind/form/ style/design/colour etc. whatsoever on any display material or media e.g. paper stationery, documents, visiting cards, magnetic devices, internet, sign board, by the members in practice and/or the firm of Chartered Accountants, be prohibited. Use/printing of member/firm name in any other manner tantamounting to logo/monogram was also prohibited.

Common CA Logo: To promote the brand of CA profession and responding to the long felt need to have a symbol of CA Profession in India, ICAI came up with a unique logo which could be used by all members, whether in practice or not. Encapsulating the current beliefs, attitudes and values of the profession, the CA Logo seeks to enhance the identity of the members. ***Guidelines issued in 2023 for using the new CA India logo for CA members prescribes that the logo consists of the letters 'CA' in blue colour with a tri colour tick mark (upside down) with white background. The blue colour not only stands out on any background but also denotes creativity, innovativeness, knowledge, integrity, trust, truth, stability, and depth. The upside-down tick mark, typically used by Chartered Accountants, has been included to symbolise the wisdom and value of the professional. 'India' is also added in the logo, as it epitomizes the Institute's connection to India First approach and commitment to the serve the Indian economy in public interest.***.

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[Students are advised to refer Chapter XVI on Logo Guidelines under Para no 9 Council Guidelines.]

Guidelines for elected Members of the Council/ office Bearers of the Regional Council in the context of use of designation etc. and manner of Printing of Letter-heads and visiting cards.

The guidelines/directions laid down by the Council as revised by the Council from time to time for use of designation etc. and manner of printing letter-heads and visiting cards of the President, Vice-President of the Institute, Members of the Council, Chairmen of various non-standing Committees of the Institute; Chairmen, other office bearers and Members of the Regional Councils; Chairmen, other office-bearers and Members of the Managing Committees of the Branches are appearing in **Appendix 'F'** to Code of Ethics publication.

Illustration 11

A practising Chartered Accountant uses a visiting card in which he designates himself, besides as Chartered Accountant, as a Tax Consultant.

Tax Consultant: Section 7 of the Chartered Accountants Act, 1949 read with Clause (7) of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public.

Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council.

Conclusion: Thus, it is improper to use designation "Tax Consultant" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council.

Illustration 12

B, a Chartered Accountant in practice is a partner in 3 firms. While printing his personal letter heads, B gave the names of all the firms in which he is a partner.

Advertisement of Professional Attainments: Clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member

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would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm on letterheads. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner.

Conclusion: Thus, B is not guilty of any misconduct under the Chartered Accountants Act, 1949.

Illustration 13

The offer document of a listed company in which Mr. D, a practising Chartered Accountant is a director mentions the name of Mr. D as a director along with his various professional attainments and spheres of specialisation.

Advertisement of Professional Attainments: The Council of the ICAI has in a communication to members stated that if a public company, in which a chartered accountant in practice is a director, issues a prospectus or gives any announcement that gives descriptions about the Chartered Accountant's expertise, specialisation and knowledge in any particular field, it shall constitute a misconduct under Clauses (6) and (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949. The Council has further stated that in such cases the member concerned has to take necessary steps to ensure that such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the members.

Conclusion: *Thus, in the instant case, Mr. D would be held to be guilty of professional mis-conduct and liable for disciplinary action.*

Illustration 14

A Chartered Accountant in practice, empanelled as an Insolvency Professional (IP) has mentioned the same on his visiting cards, letter heads and other communications also. A person residing in his neighbourhood, has filed a complaint for professional misconduct against the said member for such mention of IP.

Using Designation of Insolvency Professional: As per Clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than 'Chartered Accountant" on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

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Here, a Chartered Accountant empaneled as IP (Insolvency Professional) can mention "Insolvency Professional" on his visiting cards, letter heads and other communication, as this is a title recognised by the Central Government in terms of Clause 7 of Part 1 of First Schedule to the Chartered Accountants Act, 1949.

Conclusion: Thus, complaint of neighbor is not enforceable/ valid.

Clause (8) accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing.

It must be pointed out that professional courtesy alone is not the major reason for requiring a member to communicate with the existing accountant who is a member of the Institute or a certified auditor. The underlying objective is that the member may have an opportunity to know the reasons for the change in order to be able to safeguard his own interest, the legitimate interest of the public and the independence of the existing accountant. It is not intended, in any way, to prevent or obstruct the change. When making the inquiry from the retiring auditor, the one proposed to be appointed or already appointed should primarily find out whether there are any professional or other reasons why he should not accept the appointment.

It is important to remember that every client has an inherent right to choose his accountant also that he may, subject to compliance, with the statutory requirements in the case of limited companies, make a change whenever he chooses, whether or not the reasons which had impelled him to do so are good and valid. The change normally occurs where there has been a change of venue of business and a local accountant is preferred or where the partner who has been dealing with the client's affairs retires or dies; or where temperaments clash or the client has some good reasons to feel dissatisfied. In such cases, the retiring auditor should always accept the situation with good grace.

The existence of a dispute as regards the fees may be root cause of an auditor being changed. This would not constitute valid professional reasons on account of which an audit should not be accepted by the member to whom it is offered. However, in the case of an undisputed audit fees for carrying out the statutory audit under the Companies Act, 2013 or various other statutes having not been paid, the incoming auditor should not accept the appointment unless such fees are paid. In respect of other dues, the incoming auditor should in appropriate circumstances use his influence in favour of his predecessor to have the dispute as regards the fees settled. The professional reasons for not accepting an audit would be:

(a) Non-compliance of the provisions of Sections 139 and 140 of the Companies Act, 2013 as mentioned in Clause (9) of the Part - I of First Schedule to The Chartered Accountants Act, 1949; and

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(b) Non-payment of undisputed Audit Fees by auditees other than in case of Sick Units for carrying out the Statutory Audit under the Companies Act, 2013 or various other statutes; and

(c) Issuance of a qualified report.

In the first two cases, an auditor who accepts the audit would be guilty of professional misconduct. In this connection, attention of members is invited to the Council General Guidelines, 2008 appearing in Chapter-4. In the said Guidelines, Council has explained that the *provision for audit fee in accounts signed by both the auditee and the auditor along with other expenses, if any, incurred by the auditor in connection with the audit*, *shall* be considered as *"undisputed audit fee"* and *"sick unit"* shall mean *a unit registered for not less than five years, which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.*

In the last case, however, he may accept the audit if he is satisfied that the attitude of the retiring auditor was not proper and justified. If, on the other hand, he feels that the retiring auditor had qualified the report for good and valid reasons, he should refuse to accept the audit. There is no rule, written or unwritten, which would prevent an auditor from accepting the appointment offered to him in these circumstances. However, before accepting the audit, he should ascertain the full facts of the case. For nothing will bring the profession to disrepute so much as the knowledge amongst the public that if an auditor is found to be "inconvenient" by the client, he could readily be replaced by another who would not displease the client and this point cannot be too over-emphasised.

Where the Previous Auditor is not available for accepting payment of undisputed audit fees, and it is not otherwise possible to transfer the payment to him electronically, the Incoming Auditor may advise the client to purchase Demand Draft of the amount equivalent to undisputed Audit Fees of retiring auditor, and may accept the Audit assignment after verifying the same. It will be the duty of the Incoming auditor to ensure the payment of undisputed Audit Fees of the retiring auditor at the earliest possibility.

What should be the correct procedure to adopt when a prospective client tells you that he wants to change his auditor and wants you to take up his work? There being two persons involved, the Company and the old auditor, the former should be asked whether the retiring auditor had been informed of the intention to change. If the answer is in the affirmative, then a communication should be addressed to the retiring auditor. If, however, it is learnt that the old auditor has not been informed, and the client is not willing to make the first move, it would be necessary to ask him the reason for the proposed change. If there is no valid reason for a change, it would be healthy practice not to accept the audit. If he decides to accept the audit he should address a communication to the retiring auditor.

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As stated earlier, the object of the incoming auditor, in communicating with the retiring auditor is to ascertain from him whether there are any circumstances which warrant him not to accept the appointment.



5. For example, whether the previous auditor has been changed on account of having qualified his report or he had expressed a wish not to continue on account of something inherently wrong with the administration of the business. The retiring auditor may even give out information regarding the condition of the accounts of the client or the reason that impelled him to qualify his report. In all these cases it would be essential for the incoming auditor to carefully consider the facts before deciding whether or not he should accept the audit, and should he do so, he must also take into account the information while discharging his duties and responsibilities.

Sometimes, the retiring auditor fails without justifiable cause except a feeling of hurt because of the change, to respond to the communication of the incoming auditor. So that it may not create a deadlock, the auditor appointed can act, after waiting for a reasonable time for a reply.

The Council has taken the view that a mere posting of a letter "under certificate of posting" is not sufficient to establish communication with the retiring auditor unless there is some evidence to show that the letter has in fact reached the person communicated with. A Chartered Accountant who relies solely upon a letter posted "under certificate of posting" therefore does so at his own risk.

The view taken by the Council has been confirmed in a decision by the Rajasthan High Court in J.S. Bhati v.s. The Council of the Institute of Chartered Accountants of India and another. The following observations of the Court are relevant in this context:

"Mere obtaining a certificate of posting in my opinion does not fulfil the requirements of Clause (8) of Schedule I as the presumption under Section 114 of the Evidence Act that the letter in due course reached the addressee cannot replace that positive degree of proof of the delivery of the letter to the addressee which the letters of the law in that case required. The expression 'in 'communication with' when read in the light of the instructions contained in the booklet 'Code of Conduct' (now Code of Ethics) cannot be interpreted in any other manner but to mean that there should be positive evidence of the fact that the communication addressed to the outgoing auditor by the incoming auditor reached his hands. Certificate of posting of a letter cannot, in the circumstances, be taken as a positive proof of its delivery to the addressee".

Members should therefore communicate with a retiring auditor in such a manner as to retain in their hands **positive evidence of the delivery** of the communication to the addressee. In the opinion of the Council, the following would in the normal course provide such evidence:-

(a) Communication by a letter sent through "Registered Acknowledgement due", or

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(b) By hand against a written acknowledgement, or

(c) Acknowledgement of the communication from retiring auditor's vide email address registered with the Institute or his last known official email address, or

(d) Unique Identification Number (UDIN) generated on UDIN portal (subject to separate guidelines to be issued by the Council in this regard)

Premises found Locked: The communication received back by the Incoming Auditor with **"Office found Locked"** written on the Acknowledgement Due shall be deemed as having been delivered to the retiring auditor.

Firm not found at the given Registered address : If the Communication sent by the Incoming auditor is received back with remarks "No such office exists at this address", and the address of communication is the same as registered with the Institute on the date of dispatch, the letter will be deemed to be delivered, unless the retiring auditor proves that it was not really served and that he was not responsible for such non-service.

As a matter of professional courtesy and professional obligation it is necessary for the new auditor appointed to act jointly with the earlier auditor and to communicate with such earlier auditor.

Special Audit under Income Tax Act, 1961: It would be a healthy practice if a Tax Auditor appointed for conducting special audit under the Income Tax Act,1961 communicates with the member who has conducted the Statutory Audit.

The Council has also laid down the detailed guidelines on the subject as under:-

Communication required for all kinds of audit: The requirement for communicating with the previous auditor being a Chartered Accountant in practice would apply to all types of Audit viz., Statutory Audit, Tax Audit, GST Audit, Internal Audit, Concurrent Audit or any other kind of audit.

Communication in case of Assignments done by other professionals: A Communication is mandatorily required for all types of Audit/Report where the previous auditor is a Chartered Accountant. In case of assignments done by other professionals not being Chartered Accountants, it would also be a healthy practice to communicate.

Lack of time in acceptance of Government Audits: Although the mandatory requirement of communication with previous auditor being Chartered Accountant applies, in uniform manner, to audits of both government and Non-Government entities, yet in the case of audit of government Companies/ banks or their branches, if the appointment is made well in time to enable the obligation cast under this clause to be fulfilled, such obligation must be complied with before accepting the audit. However, in case the time schedule given for the assignment is such that there is no time to

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wait for the reply from the outgoing auditor, the incoming auditor may give a conditional acceptance of the appointment and commence the work which needs to be attended to immediately after he has sent the communication to the previous auditor in accordance with this clause. In his acceptance letter, he should make clear to the client that his acceptance of appointment is subject to professional objections, if any, from the previous auditors and that he will decide about his final acceptance after taking into account the information received from the previous auditor.

Illustration 15

Mr. X, a Chartered Accountant accepted his appointment as tax auditor of a firm under Section 44AB, of the Income-tax Act,1961 and commenced the tax audit within two days of his appointment since the client was in a hurry to file Return of Income before the due date. After commencing the audit, Mr. X realised his mistake of accepting this tax audit without sending any communication to the previous tax auditor. In order to rectify his mistake, before signing the tax audit report, he sent a registered post to the previous auditor and obtained the postal acknowledgement. Will Mr. X be held guilty under the Chartered Accountants Act?

Communication with the Previous Auditor: As per Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949, Mr. X will be held guilty since he has accepted the tax audit, without first communicating with the previous auditor in writing. The object of the incoming auditor communicating in writing with the retiring auditor is to ascertain whether there are any circumstances which warrant him not to accept the appointment, for example, whether the previous auditor has been changed on account of having qualified the report or he had expressed a wish not to continue on account of something inherently wrong with the administration of the business. The retiring auditor may even give out information regarding the condition of the accounts of the client or the reason that impelled him to qualify his report. Under all circumstances, it would be essential for the incoming auditor to carefully consider the facts before deciding whether or not he should accept the audit. As a matter of professional courtesy and professional obligation it is necessary for the new auditor appointed to communicate with such earlier auditor.

Conclusion: Therefore, Mr. X will be held guilty of professional misconduct.

Illustration 16

W, a Chartered Accountant had sent letters under certificate of posting to the previous auditor informing him his appointment as an auditor before the commencement of audit by him.

Communication with the Previous Auditor: Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 requires communication by the incoming auditor with the

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previous auditor before accepting a position by him. The Council of the Institute has taken the view that a mere posting of a letter "under certificate of posting" is not sufficient to establish communication with the retiring auditor unless there is some evidence to show that the letter has in fact reached the person communicated with. A Chartered Accountant who relies solely upon a letter posted "under certificate of posting" therefore does so at his own risk. Since the letters were sent by "W" to the previous auditor informing him of his appointment as an auditor before the commencement of audit by him under Certificate of Posting is not sufficient to prove communication with the retiring auditor. In the opinion of the Council, communication by a letter sent "Registered Acknowledgement Due" or by hand against a written acknowledgement would in the normal course provide positive evidence.

Conclusion: Hence "W" was guilty of professional misconduct under Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949

Clause (9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 (1 of 1956), or sections 139 to 141 of the Companies Act, 2013 or any other law pertaining to appointment of auditors for the time being in force, in respect of such appointment have been duly complied with;**

The Companies Act, 2013 provides for the requirements which an auditor appointed in respect of a Company should satisfy himself about, before he accepts the appointment. The relevant provisions are contained in Section 139 and 140 of the Companies Act, 2013 Act (erstwhile Section 225 of the Companies Act, 1956) and the Council has notified that the provisions to be complied with under Clause (9) are those contained in Sections 139 and 140 of the Act. Section 139 contains several provisions in the matter of appointment of auditors in different circumstances and situations whereas Section 140 lays down the procedure which must be followed whenever a Company desires to change its auditors. In order that the validity of the appointment of an auditor is not challenged or objected to by shareholders or the retiring auditors at a later date, it has been made obligatory on the Incoming Auditor to ascertain from the Company that the appropriate procedure in the matter of appointment has been faithfully followed.

The following guidelines have been issued by the Council for this purpose:-

Clause (9) of Part I of the First Schedule to Chartered Accountants Act, 1949 provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a Company without first ascertaining from it whether the requirements of Sections 139 and 140 of the Companies Act, 2013, in respect of such appointment have been duly complied with. Under this clause it is obligatory on the incoming auditor to ascertain from the Company that the appropriate procedure in the matter of his appointment has been duly complied with so that no shareholder or retiring auditor may, at a later date, challenge the validity of such appointment.

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The steps to be taken by an Auditor of a Company who is appointed in the following circumstances are indicated in the paragraphs below:

(a) When the auditor appointed is the First Auditor of the Company.

(b) When the auditor is appointed in place of an existing auditor who has resigned or has been removed or has ceased to hold office for any other reason.

(c) When the auditor or auditors appointed by the Company were holding this office jointly with others and one or more of such joint auditors are not reappointed.

(d) When one or more of the auditors appointed by the Company was/were not holding this office earlier.

Note : Students are advised to refer Intermediate level Paper 2 Corporate and Other Law for more details regarding Section 139 and 140, Section 139 of the Companies Act, 2013 laid down the procedure to be followed by a Company for appointment of an auditor and Section 140 of the Companies Act, 2013 lays down the procedure for appointment of auditor other than the retiring auditor and for removal of existing auditor.

The procedure to be followed by the Company is given below:-

- If a member of the Company wants that the retiring auditor should not be reappointed or that an auditor other than the retiring auditor should be appointed, he has to give a special notice u/s 140(4) of the Companies Act, 2013 to the Company for a resolution at the Annual General Meeting for this purpose.
- Such special notice is also required to be given if a member of the Company wants to remove the auditor before the expiry of his term of office. The special notice should be given before the date of the General Meeting when the question of appointment or reappointment of the auditor is to be considered.
- On receipt of the special notice of such a resolution, the Company has to send a copy of the same to the retiring auditor forthwith, as required u/s 140(4) of the Companies Act, 2013.
- The Company is also required to send the special notice to the members of the Company at least seven days before the Meeting as per the provisions of Section 115 read with Section 20 of the Companies Act, 2013. According to these provisions, a document may be served on a company or an officer thereof by sending it to the company or the officer at the registered office of the company by registered post or by speed post or by courier service or by leaving it at its registered office or by means of such electronic or other mode as may be prescribed.

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- After receipt of the above notice, the retiring auditor can submit his representation to the members of the Company. Such representation, on receipt by the Company, is required to be sent to its members as required under Section 140(4) of the Companies Act.
- The representation received from the retiring auditor will have to be considered at the General Meeting of the Company before the resolution proposed by the concerned member is passed. The resolution proposed by the concerned member can be passed only in accordance with the provisions of Section 114 of the Companies Act, 2013.
- Under Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949, the incoming auditor has to ascertain whether the Company has complied with the provisions of the above sections. The word "ascertain" means “to find out for certain”. This would mean that the incoming auditor should find out for certain as to whether the Company has complied with the provisions of Sections 139 and, 140 of the Companies Act, 2013. In this respect, it would not be sufficient for the incoming auditor to accept a certificate from the management of the Company that the provisions of the above sections have been complied with. It is necessary for the incoming auditor to verify the relevant records of the Company and ascertain as to whether the Company has, in fact, complied with the provisions of the above sections. If the Company is not willing to allow the incoming auditor to verify the relevant records in order to enable him to ascertain as to whether the provisions of the above sections have been complied with, the incoming auditor should not accept the audit assignment.

It is suggested that the incoming auditor should verify the following records of the Company:-

If the appointment of the auditor is being made for the first time after incorporation of the Company, the auditor should verify as to whether the Board of Directors have passed the resolution for his appointment within thirty days of the date of registration of the Company.

If the Board of Directors have not appointed the first auditor but the appointment is being made by a general meeting of the Company, the auditor should verify as to whether a proper notice convening the general meeting has been issued by the Company and whether the resolution has been validly passed at the general meeting of the Company.

If the appointment is being made to fill a casual vacancy, the incoming auditor should verify as to whether the Board of Directors have powers to fill the casual vacancy and whether the Board of Directors have passed the resolution filling the casual vacancy.

If the vacancy has arisen due to resignation of the auditor, the incoming auditor should see as to whether a proper resolution filling the vacancy has been passed at the General Meeting of the Company.

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If the vacancy has arisen as a result of removal of the auditor before the expiry of his term of office, the incoming auditor should see that special resolution has been passed at the General Meeting of the Company and that the previous approval of the Central Government has been obtained by the Company.

Where the auditor other than the retiring auditor is proposed to be appointed, the incoming auditor should ascertain whether the provisions of Sections 139 and 140 have been complied with. These provisions equally apply where an auditor who was jointly holding office with another auditor or auditors and any one or more of such joint auditors has not been reappointed.

For the purpose of ascertaining whether the Company has complied with the provisions of Section 140 of the Companies Act the incoming auditor should verify the records of the Company in respect of the following matters:-

a. Whether a member of the Company has given special notice of the resolution as required under Section 140 (4) of the Companies Act, 2013. The notice shall be sent by members to the company not earlier than three months but at least fourteen days before the date of the meeting at which the resolution is to be moved, exclusive of the day on which the notice is given and the day of the meeting. A true copy of this notice should be obtained by the incoming auditor.

b. Whether this special notice has been sent to all the members, of the Company as required under Section 115 of the Companies Act, 2013 at least 7 days before the date of the General Meeting.

c. Whether this special notice has been sent to the retiring auditor forthwith as required under Section 140 (4).

d. Whether the representation received from the retiring auditor has been sent to the members of the Company as required under Section 140 (4).

e. Whether the representation received from the retiring auditor has been considered at the general meeting and the resolution proposed by the special notice has been properly passed at the general meeting.

As regards the mode of sending the notice of the resolution to the members of the Company as provided in Sections 139 and 140 and section 20 to be followed for service of documents, which is as under:-

(A) A document may be served on a company or an officer thereof by sending it to the company or the officer at the registered office of the company by registered post or by speed post or

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by courier service or by leaving it at its registered office or by means of such electronic or other mode as may be prescribed.

(B) As regards the mode of sending the notice of the resolution to the retiring auditor as provided in Sections 224 & 225 of Companies Act, 1956 (equivalent Sections being Section 139 & 140 of Companies Act, 2013), attention is invited to the Department of Company Affairs circular dated 17.10.1981 issued to all Chambers of Commerce, which is reproduced below:-

"I am directed to say that it has been reported by the Institute of Chartered Accountants of India that difficulties are being experienced by retiring Auditors in the operation of the provisions of Section 225 of the Companies Act, 1956 whenever any appointment of a new auditor takes place. Such difficulties arise because of the fact that the copy of the special notice required to be served u/s 225(2) of the Act on the retiring auditors are not effectively served and proof of such service is not available. To obviate such difficulties; therefore, it is advisable that the copy of the special notice u/s 225(2) of the Act should be sent to the retiring auditors by Registered A/D post."

(C) Accordingly, it is necessary for the incoming auditor to satisfy himself that the notice provided for in Sections 139 & 140 of the Companies Act, 2013 has been effectively served on the outgoing auditor (e.g. by seeing that the notice has been duly served through hand delivery or by Regd. Post with A.D.). Production of a certificate of posting by the Company would not be adequate for the purpose of the incoming auditor satisfying himself about compliance with Sections 139/140. Acknowledgement received from the outgoing auditor would be one of the forms in which such satisfaction can be obtained.

A copy of the relevant minutes of the general meeting where the above resolution is passed duly verified by the Chairman of the meeting should also be obtained by the incoming auditor for his records.

Sometimes the annual general meeting is adjourned without conducting any business or after conducting business in respect of some of the items on the agenda. The items in respect of which the business is conducted may or may not include the item relating to appointment of auditors. Under Section 139(1) the retiring auditor holds office till the conclusion of every sixth annual general meeting. Therefore, when the annual general meeting is adjourned in the circumstances stated above, the retiring auditor will continue to hold the office of auditor till the adjourned meeting is held and the business listed in the agenda of the meeting is concluded. In case a new auditor is appointed at the original meeting (which is adjourned) such auditor can assume office only after the conclusion of such adjourned meeting.

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If any annual general meeting is adjourned without appointing an auditor, no special notice for removal or replacement of the retiring auditor received after the adjournment can be taken note of and acted upon by the Company, since in terms of Section 115 of the Companies Act, special notice should be given to the Company at least fourteen clear days before the meeting in which the subject matter of the notice is to be considered. The meeting contemplated in Section 115 undoubtedly is the original meeting. Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company mentioned in Section 139.

If the incoming auditor is satisfied that the Company has complied with the provisions of Sections 139 and 140 of the Companies Act, he should first communicate with the outgoing auditor in writing as provided in Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 before accepting the audit assignment.

Unjustified removal of auditors: In order to examine various ethical issues and safeguard the independence of the Auditors, the Council has set up a Ethical Standards Board (ESB). This Board examines various issues concerning professional ethics governing the members of the Institute which are either raised by the members or are taken up based on their importance. The recommendations of the Board are forwarded to the Council for its consideration. This Board is also charged with the responsibility of looking into the cases of removal and resignation of auditors and making an appropriate report to the Council.

The following guidelines have been issued for the Board for looking into the cases of Removal of Auditors:
A. Where an auditor resigns his appointment as an auditor of a Company or does not offer himself for reappointment as auditor of such Company, he shall send a communication, in writing, to the Board of Directors of the Company giving reasons therefor, if he considers that there are professional reasons connected with his resignation or not offering himself for re-appointment which, in his opinion, should be brought to the notice of the Board of Directors, and shall send a copy of such communication to the Institute. It shall be obligatory on the incoming auditor, before accepting appointment, to obtain a copy of such communication from the Board of Directors and consider the same before accepting the appointment.
B. Where an auditor, though willing for re-appointment has not been reappointed, he shall file with the Institute a copy of the statement which he may have sent to the management of the Company for circulation among the shareholders. It shall be obligatory on the incoming auditor before accepting the appointment, to obtain a copy of such a communication from the Company and consider it, before accepting the appointment.

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C. The Ethical Standards Board, on a review of the communications referred to in paras (A) and (B), may call for such further information as it may require from the incoming auditor, the outgoing auditor and the Company and make a report to the Council in cases where it considers necessary.

D. The above procedure is also followed in the case of removal of auditors by the government and other statutory authorities.

[Note: Students are advised to refer Appendix 'G' For the Mission Statement, Terms of Reference and Procedure to be followed by the Board for dealing with the cases of Unjustified Removal of Auditors.]

Illustration 17

CA Raja was appointed as the Auditor of Castle Ltd. for the year 2023-24. Since he declined to accept the appointment, the Board of Directors appointed CA Rani as the auditor in the place of CA Raja, which was also accepted by CA Rani.

Appointment of Auditor by Board: Board can appoint the auditor in the case of casual vacancy under section 139(8) of the Companies Act, 2013. The non-acceptance of appointment by CA Raja does not constitute a casual vacancy to be filled by the Board. In this case, it will be deemed that no auditor was appointed in the AGM.

Further, as per Section 139(10) of the Companies Act, 2013 when at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company. The appointment of the auditor by the Board is defective in law.

Clause (9) of Part I of First Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant is deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of section 225 of the Companies Act, 1956 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been fully complied with.

Conclusion: Hence, CA Rani is guilty of professional misconduct since she accepted the appointment without verification of statutory requirements.

Illustration 18

Mr. X is a Chartered Accountant accepted the appointment as Statutory Auditor of the Company ABC Ltd. without communicating with the previous auditor before accepting the audit. He also

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failed to ascertain the compliance of requirement of Section 139 and 140 of the Companies Act, 2013 in respect of the appointments have been duly complied with.

Communication by incoming auditor with previous auditor: Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 requires communication by the incoming auditor with the previous auditor before accepting a position by him.

Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 (now Section 139 and 140 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Under this clause it is obligatory on the incoming auditor to communicate with previous auditor and ascertain from the Company that the appropriate procedure in the matter of his appointment has been duly complied with so that no shareholder or retiring auditor may, at a later date, challenge the validity of such appointment.

In this case Mr. X accepted the appointment as Statutory Auditor of the Company ABC Ltd. without communicating with the previous auditor. Further, he accepted the appointment without first ascertaining whether the requirement of Section 139 and 140 of the Companies Act, 2013 in respect of the appointments have been duly complied with.

Conclusion: Therefore, Mr. X is liable for misconduct under clause 8 and Clause 9 since he accepted the appointment without communicating with previous auditor as well as for not verifying the compliance of statutory requirements.

Clause (10) charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

What distinguishes a profession from a business is that professional services are not rendered with the sole purpose of a profit motive. Personal gain is one but not the main or the only objective. Professional opinion, therefore frowns upon methods where payment is made to depend on the basis of results. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the advantage of his service or may adopt means that are not ethical. It will have the effect of undermining his integrity and impairing his independence. Therefore, members are prohibited from charging or accepting any remuneration

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based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings.

Professional services should not be offered or rendered under an arrangement whereby no fee will be charged unless a specified finding or result is obtained or where the fee is otherwise contingent upon the findings or results of such services. However, fees should not be regarded as being contingent if fixed by a court or other public authority.

The Council of the Institute has however framed Regulation 192 which exempts members from the operation of this clause in certain professional services. The said Regulation 192 is reproduced -

192. Restriction on fees - No Chartered Accountant in practice shall charge or offer to charge, accept or offer to accept, in respect of any professional work, fees which are based on a percentage of profits, or which are contingent upon the findings or results of such work, provided that:

(a) "In the case of a receiver or a liquidator, the fees may be based on a percentage of the realization or disbursement of the assets;

(b) In the case of an auditor of a co-operative society, the fees may be based on a percentage of the paid up capital or the working capital or the gross or net income or profits;

(c) In the case of a valuer for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of property valued;

(d) in the case of certain management consultancy services as may be decided by the resolution of the Council from time to time, the fees may be based on percentage basis which may be contingent upon the findings, or results of such work;

(e) in the case of certain fund raising services, the fees may be based on a percentage of the fund raised;

(f) in the case of debt recovery services, the fees may be based on a percentage of the debt recovered;

(g) in the case of services related to cost optimisation, the fees may be based on a percentage of the benefit derived; and

(h) any other service or audit as may be decided by the Council. [**Following activities have been decided by the Council under "h" above :-(i) Acting as Insolvency Professional;(ii) Non-Assurance Services to Non-Audit Clients]**

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Illustration 19

Mr. P a practicing chartered accountant acting as liquidator of AB & Co. charged his professional fees on percentage of the realization of assets.

Restriction on fees based on a Percentage: According to Clause (10) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

However, CA Regulation allow the Chartered Accountant in practice to charge the fees in respect of any professional work which are based on a percentage of profits, or which are contingent upon the findings or results of such work, in the case of a receiver or a liquidator, and the fees may be based on a percentage of the realization or disbursement of the assets.

In the given case, Mr. P, a practicing Chartered Accountant, has acted as liquidator of AB & Co. and charged his professional fees on percentage of the realisation of assets.

Conclusion: Therefore, Mr. P shall not be held guilty of professional misconduct as he is allowed to charge fees on percentage of the realisation of assets being a liquidator.

Clause (11) engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company (Not being managing director or a whole time director) unless he or any of his partners is interested in such company as an auditor.

This is a provision introduced to restrain a member in practice from engaging himself in any business or occupation other than that of chartered accountant except when permitted by the Council to be so engaged. The objective is to restrain members from carrying on any other business in conjunction with the profession of accountancy and combining such work with any business, which is not in keeping with the dignity of the profession. Another reason for the introduction of such prohibition is that a chartered accountant, if permitted to enter into all kinds of business, would be able to advertise for his other business and thereby secure an unfair advantage in his professional practice.

The Council, on a very careful consideration of the matter, has formulated Regulation, 190A and 191 which are reproduced below, specifying the activities with which a member in practice can associate himself with or without the permission of the Council.

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190A. Chartered Accountant in practice not to engage in any other business or occupation.

"A chartered accountant in practice not to engage in any other business or occupation other than the profession of accountancy except with the permission granted in accordance with a resolution of the Council".

191. Part-time employment a Chartered Accountant in practice may accept.

"Notwithstanding anything contained in Regulation 190A but subject to the control of the Council, a Chartered Accountant in practice may act as a liquidator, trustee, executor, administrator, arbitrator, receiver, adviser or representative for costing, financial or taxation matter, or may take up an appointment that may be made by the Central Government or a State Government or a court of law or any other legal authority or may act as a Secretary in his professional capacity, provided his employment is not on a salary-cum-full-time basis".

Appendix 9 C.A. Regulations, 1988

The General and specific Resolutions passed by the Council under the power vested in it under Regulation 190A as included in Appendix 9 of C.A. Regulations, 1988 are also reproduced below for information.

General Resolution

Permission granted generally - Members of the Institute in practice be generally permitted to engage in the following categories of occupations, for which no specific permission from the Council would be necessary in individual cases:

(1) Employment under Chartered Accountants in practice or firms of such chartered accountants.

(2) Private tutorship.

(3) Authorship of books and articles.

(4) Holding of Life Insurance Agency License for the limited purpose of getting renewal commission.

(5) Attending classes and appearing for any examination.

(6) Holding of public elective offices such as M.P., M.L.A. and M.L.C.

(7) Honorary office leadership of charitable-educational or other non-commercial organisations.

(8) Acting as Notary Public, Justice of the Peace, Special Executive Magistrate and the like.

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(9) Part-time tutorship under the coaching organisation of the Institute.

(10) Valuation of papers, acting as paper-setter, head-examiner or a moderator, for any examination.

(11) Editorship of professional journals.

(12) Acting as Surveyor and Loss Assessor under the Insurance Act, 1938 provided they are otherwise eligible.

(13) Acting as recovery consultant in the banking sector

(14) Owning agricultural land and carrying out agricultural activity (w.e.f. August 9th, 2008).

Specific Resolution - Members of the Institute in practice may engage in the following categories of business or occupations, after obtaining the specific and prior approval of the Council in each case:

(1) Full-time or part-time employment in business concerns provided that the member and/or his relatives do not hold "substantial interest" in such concerns.

(2) Full-time or part-time employment in non-business concern.

(3) Office of managing director or a whole-time director of a body corporate within the meaning of the Companies Act, 1956 (now Companies Act, 2013) provided that the member and/or any of his relatives do not hold substantial interest in such concern.

(4) Interest in family business concerns (including such interest devolving on the members as a result of inheritance / succession / partition of the family business) or concerns in which interest has been acquired as a result of relationships and in the management of which no active part is taken.

(5) Interest in an educational institution.

(6) Part-time or full-time lectureship for courses other than those relating to the Institute's examinations conducted under the auspices of the Institute or the Regional councils or their branches.

(7) Part-time or full-time tutorship under any educational institution other than the coaching organization of the Institute.

(8) Editorship of journals other than professional journals.

(9) Any other business or occupation for which the Executive Committee considers that permission may be granted.

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However, it is open to the Council to refuse permission in individual cases though covered under any of the above categories. For the purpose of the above resolution:

(i) the expression "relative", in relation to a member, means the husband, wife, brother or sister or any lineal ascendant or descendant of that member;

(ii) a member shall be deemed to have a "substantial interest" in a concern -

(i) in a case where the concern is a Company, if its shares (not being shares entitled to a fixed rate of dividend whether with or without a further right to participate in profits) carrying not less than twenty per cent of voting power at any time, during the relevant years are owned beneficially by such member or by any one or more of the following persons or partly by such member and partly by one or more of the following persons:

(a) One or more relatives of the member;

(b) Any concerns in which any of the persons referred to above has a substantial interest;

(ii) in the case of any other concern, if such member is entitled or the other persons referred to above or such member and one or more of the other persons referred to above are entitled in the aggregate, at any time during the relevant years to not less than twenty percent of the profits of such concern.

Attention of the members is also invited to para 3 of the above Resolution relating to the holding of office of a managing director or a whole-time director in a company. In such cases, a member can accept the office of a managing director or a whole- time director only after obtaining, the specific and prior approval of the Council. Attention of the members is also invited to the provisions of Section 2(26) of the Companies Act, 1956 (now Section 2(54) of the Companies Act, 2013) under which even where a person is not designated as a managing director or a whole-time director, he can be deemed to be a managing director or a whole-time director if he is entrusted with the whole or substantially the whole of the management of the affairs of the company. It may be pointed out that a member cannot accept and hold the office of a managing director or a whole-time director in a company if the member and/or his partners and relatives hold substantial interest in such a company.

The Council has considered the question of permitting members in practice to become a Director, Managing Director, full time/Executive Director etc. and related issues and the following decisions have been taken.

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As regards the question of permitting member in practice to be a Director, Promoter/Promoter-Director, Subscriber to the Memorandum and Articles of Association of any company including a board managed company, it was decided that -

(a) Director of a Company

(i) The expression "Director Simplicitor" means an ordinary / simple Director who is not a Managing Director or Whole time Director and is required only in the Board Meetings of the company and not paid any remuneration except for attending such meetings.

(ii) A member in practice is permitted generally to be a Director Simplicitor in any Company including a board-managed Company and as such he is not required to obtain any specific permission of the Council in this behalf unless he or any of his partners is interested in such Company as an auditor, irrespective of whether he and/or his relatives hold substantial interest in that Company.

A question arises, whether the auditor of a Subsidiary Company can be a Director of its Holding Company-

The Ethical Standard Board (ESB) noted that, in terms of Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949 a Chartered Accountant in practice cannot engage (unless permitted by the Council so to engage) in any business or occupation other that the profession of Chartered Accountant but he can be a director of a Company (not being a managing director or whole-time director) wherein he or any of his partners is not interested in such company as an auditor. The Board further noted that Public conscience is expected to be ahead of the law. Members, therefore, are expected to interpret the requirement as regards independence much more strictly than what the law requires and should not place themselves in positions which would either compromise or jeopardise their independence. In view of the above, the Board, via a clarification, decided that the auditor of a Subsidiary Company can't be a Director of its Holding Company, as it will affect the independence of an auditor.

(b) Promoter/Promoter Director - There is no bar for a member to be a promoter / signatory to the Memorandum and Articles of Association of any company. There is also no bar for such a promoter / signatory to be a Director Simplicitor of that company irrespective of whether the object of the company include areas which fall within the scope of the profession of Chartered Accountants. Therefore, members are not required to obtain specific permission of the Council in such cases. It must be clarified that under Section 25 of the Chartered Accountants Act, no Company can practise as a Chartered Accountant.

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(c) Member in practice in a HUF doing business - "A member of the Institute can acquire interest in family business in any of the following manner:

(i) as a proprietary firm

(ii) as a partnership firm

(iii) in the name and style of Hindu Undivided Family as its Karta or a member.

It would be necessary for the members to provide evidence that interest in the family business concern devolved on him as a result of inheritance/succession/partition of the family business. It is also necessary for the member to show that he was not actively engaged in carrying on the said business and that the family business concern in question was not created by himself.

To establish his case, the member should furnish a declaration in the prescribed format and the documents evidencing above for consideration to the concerned Decentralized Office."

A member in practice engaged as Karta of a HUF doing family business, will be within the limit prescribed by Council if he makes investments from the funds pertaining to HUF only, provided, he is not actively engaged in the management of the said business.

Students may also note that as per decision taken by appropriate authority in Council, Regulation 190A of the Chartered Accountants Regulations, 1988 provides that a chartered accountant in practice shall not engage in any business or occupation other than the profession of accountancy, except with the permission granted in accordance with a resolution of the Council. The Council has passed a Resolution under Regulation 190A granting general permission (for private tutorship, and part-time tutorship under Coaching organization of the Institute) and specific permission (for part-time or full-time tutorship under any educational institution other than Coaching organization of the Institute). Such general and specific permission granted is subject to the condition that the direct teaching hours devoted to such activities taken together should not exceed 25 hours a week in order to be able to undertake attest functions.

Illustration 20

A chartered accountant holding certificate of practice and having four articled clerks registered under him accepts appointment as a full-time lecturer in a college. Also, he becomes a partner with his brother in a business. Examine his conduct in the light of the Chartered Accountants Act, 1949 and the regulations thereunder.

Specific Permission to be Obtained: Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949 debars a chartered accountant in practice from engaging in any business or occupation other than the profession of chartered accountancy unless permitted by the Council

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of the Institute so to engage. This clause, in effect, has empowered the Council of the Institute to permit chartered accountants in practice to engage in any other business or occupation considered fit and proper. Accordingly, the Council had formulated Regulations 190A and 191 to the Chartered Accountants Regulations, 1988 to provide a basis for considering applications of chartered accountants seeking permission to engage in other business or occupation. A member can accept full- time lecturer-ship in a college only after obtaining the specific and prior approval of the Council as also becoming a partner in a business with his brother would require specific permission.

Conclusion: Thus, the chartered accountant is liable for professional misconduct since he failed to obtain specific and prior approval of the Council in each case.

Illustration 21

Mr. A, a practicing Chartered Accountant, took over as the executive chairman of Software Company on 01-04-2024. On 10-04-2024 he applied to the Council for permission.

Specific Permission to be Obtained: As per Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

In the instant case, Mr. A took over as the executive chairman on 01-04-2024 and applied for permission on 10-04-2024. On the basis of these facts, he was engaged in other occupation between the period 01-04-2024 and 10-04-2024, without the permission of the Council. **Conclusion:** Therefore, Mr. A is guilty of professional misconduct in terms of Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Illustration 22

CA Moksh, a leading income tax practitioner based in Mumbai with exceptional writing skills, also serves as the editor of a non-chartered accountancy-related journal. He devotes approximately 50% of his time to managing the journal's editorial responsibilities of this journal. Is CA Moksh liable for professional misconduct?

Engaging into a Business: As per Clause (11) of Part I of First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

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However, the Council has granted general permission to the members to engage in certain specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In this case, CA Moksh is engaged in the occupation of editorship of journals other than professional journals which is not covered under the general permission.

Conclusion: Hence, specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under Clause (11) of Part I of First Schedule of the Chartered Accountants Act, 1949.

Clause (12) allows a person not being a member of the institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

The above clause prohibits a member from allowing another member who is not his partner to sign any balance sheet, profit and loss account or financial statements on his behalf or on behalf of his firm.

This clause is to be read in conjunction with Section 26 of the Chartered Accountants Act, 1949 which stipulates that 'No person other than a member of the Institute shall sign any document on behalf of a Chartered Accountant in practice or a firm of Chartered Accountants in his or its professional capacity'.

The term 'financial statement' for the purposes of this clause would cover an examination of the accounts or of financial statements given under a statutory enactment or otherwise. A report, however, may cover a wider range of documents but in the context in which it is used in this clause, it would mean only a report arising out of a professional assignment undertaken by him or his firm and submitted by him or his firm to the client(s) or where so required, to an outsider on behalf of himself or on behalf of the firm. The subject matter of report should be the expression of a professional opinion whether, financial or non-financial. The financial statements and the reports referred to in this clause obviously means the financial statements and reports as ultimately finalized and submitted to the outside authorities.

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated in the following instances and such delegation will not attract provisions of this clause:

(i) Issue of audit queries during the course of audit.

(ii) Asking for information or issue of questionnaire.

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(iii) Letter forwarding draft observations/financial statements.

(iv) Initiating and stamping of vouchers and of schedules prepared for the purpose of audit.

(v) Acknowledging and carrying on routine correspondence with clients.

(vi) Issue of memorandum of cash verification and other physical verification or recording the results thereof in the books of the clients.

(vii) Issuing acknowledgements for records produced.

(viii) Raising of bills and issuing acknowledgements for money receipts.

(ix) Attending to routine matters in tax practice, subject to provisions of Section 288 of the Income-tax Act, 1961.

(x) Any other matter incidental to the office administration and routine work involved in practice of accountancy.

It is also clarified that where the authority to sign documents given above is delegated by a chartered accountant or by a firm of chartered accountants the fact that the documents have not been signed by a chartered accountant is not a defence to him or to the firm in an enquiry relating to professional misconduct.

However, the Council has decided that where a Chartered Accountant while signing a report or, a financial statement or any other document is statutorily required to disclose his name, the member should disclose his name while appending his signature on the report or document. Where there is no such statutory requirement, the member may sign in the name of the firm. It may be noted that the revised SA 700 mandates mentioning of Membership No. and Firm Registration No. Members' attention is also drawn towards UDIN Guidelines of the Institute in 2018.

Illustration 23

S, a practicing Chartered Accountant gives power of attorney to an employee Chartered Accountant to sign reports and financial statements on his behalf.

Power of Signing Reports and Financial Statements: Under Clause (12) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

This clause read in conjunction with Section 26 of the Chartered Accountants Act, 1949 stipulates that no person other than the member of the institute shall sign any document on behalf of a Chartered

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Accountant in practice or a firm of Chartered Accountants in his or its professional capacity.

The term 'Financial Statement' for this purpose would cover an examination of the accounts or financial statements given under a statutory enactment or otherwise.

Further, Clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

Conclusion: Accordingly, S is guilty of professional misconduct under Clause (12) of Part I of First Schedule and also under Clause (1) of Part II of Second Schedule for contravening Section 26.

Illustration 24

CA Smart, a practicing Chartered Accountant was on Europe tour between 15-09-24 and 25-09-24. On 18-09-24 a message was received from one of his clients requesting a stock certificate to be produced to the bank on or before 20-09-24. Due to urgency, CA Smart directed his assistant, who is also a Chartered Accountant, to sign and issue the stock certificate after due verification, on his behalf.

Allowing a Member Not Being a Partner to Sign Certificate: As per Clause (12) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct "if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements".

In this case, CA Smart allowed his assistant who is not a partner but a member of the Institute of Chartered Accountants of India to sign stock certificate on his behalf and thereby commits misconduct.

Conclusion: Thus, CA Smart is guilty of professional misconduct under Clause (12) of Part I of First Schedule to the Chartered Accountants Act, 1949.

PART II - Professional misconduct in relation to members of the Institute in service

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person-

Clause (1) pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him.

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A member of the Institute in service is deemed to be guilty of professional misconduct, if he is an employee of any company, firm or person and during that course whatever emoluments he receives, if he either pays or allows to pay or agree to pay any part or share thereof whether directly or indirectly. However, this clause does not restricts such sharing or commitments among relatives, dependents, friends etc., if there is no relationship in procuring or retaining the job and payment is not a consideration for job procurement or retainership.

The clear verdict of this clause is that job must be procured and retained with own professional capabilities and not by any financial deal impairing professional dignity.

Clause (2) accepts or agrees to accept any part of fees, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

This clause restricts to accept or agrees to accept any part of fee, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification. The objective is that when a member is in employment, he must maintain high level of ethics and should not accept any other amount from anyone for which he is not entitled from employer under contractual agreement of service.

[Note: A member in the foregoing circumstances would be guilty of misconduct regardless of the fact that he was in whole-time or part-time employment or that he was holding Certificate of Practice along with his employment.]

Illustration 25

Mr. 'C', a Chartered Accountant holds a certificate of practice while in employment also, recommends a particular lawyer to his employer in respect of a case. The lawyer, out of the professional fee received from employer paid a particular sum as referral fee to Mr. 'C'.

Referral Fee from Lawyer: According to Clause (2) of Part II of First Schedule of the Chartered Accountant Act, 1949, a member of the Institute(other than a member in practice) shall be guilty of professional misconduct, if he being an employee of any company, firm or person accepts or agrees to accept any part of fee, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

In the present case, Mr. C, who beside holding a certificate of practice, is also an employee and by referring a lawyer to the company in respect of a case, he receives a particular sum as referral fee from the lawyer out of his professional fee.

Conclusion: Therefore, Mr. C is guilty of professional misconduct by virtue of Clause (2) of Part II of First schedule.

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PART III - Professional misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he -

Clause (1) not being a fellow of the Institute, acts as a fellow of the Institute.

Clause (2) does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority.

Where a Chartered Accountant had not disclosed to the Institute at any time about his engagement as a proprietor of a non-chartered accountant's firm while holding certificate of practice and had not furnished particulars of his engagement as Director of a company despite various letters of the institute which remained unreplied. Held that he was guilty under Clause (11) of Part I and Clauses (1) and (3) of Part III of the First Schedule.

Where a Chartered Accountant had continued to train an articled clerk though his name was removed from the membership of the Institute and he had failed to send any reply to the Institute asking him to send his explanation as to how he was training as his articled clerk when he was not a member of the Institute. Held that he was guilty under Clause (2) of Part III of the First Schedule.

Illustration 26

Mr. 'G', while applying for a certificate of practice, did not fill in the columns which solicit information about his engagement in other occupation or business, while he was indeed engaged in a business.

Disclosure of Information: As per Clause (2) of Part III of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant, in practice or not, does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority;

In the given case, Mr. "G", a Chartered Accountant while applying for a certificate of practice, did not fill in the columns which solicit information about his engagement in other occupation or business, while he was indeed engaged in a business. Details of engagement in business need to be disclosed while applying for the certificate of practice as it was the information called for in the application, by the Institute.

Conclusion: Thus, Mr. G will be held guilty of professional misconduct under Clause (2) of Part III of First Schedule of the Chartered Accountants Act, 1949.

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Illustration 27

Mr. X, a Chartered Accountant, employed as a paid Assistant with a Chartered Accountant firm, leaves the services of the firm on 31st December, 2024. Despite many reminders from ICAI he fails to reply regarding the date of leaving the services of the firm.

Failed to Supply Information Called For: As per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949, a member, whether in practice or not, will be deemed to be guilty of professional misconduct if he does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate authority.

Conclusion: Thus, in the given case, Mr. X has failed to reply to the letters of the Institute asking him to confirm the date of leaving the service as a paid assistant. Therefore, he is held guilty of professional misconduct as per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949.

Clause (3) while inviting professional work from another chartered accountant or while responding to tenders or enquiries or while advertising through a write up, or anything as provided for in items (6) and (7) of Part I of this Schedule, gives information knowing it to be false.

Any member of the Institute, in the course of procurement of professional work from another Chartered Accountant or from any other source provides or renders any information which he knows to be false through any documents, or acts (like tenders, enquiries, response to advertisement, CV type write ups etc.), he would be deemed guilty of professional misconduct under Clause (3), Part III of First Schedule.

PART IV- Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he -

Clause (1) is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months.

Clause (2) in the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

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Illustration 28

YKS & Co., a proprietary firm of Chartered Accountants, was appointed as a concurrent auditor of a bank. YKS, the proprietor, used his influence to get a loan and thereafter failed to repay the loan.

Disrepute to the Profession: This is a case which is covered under the expression in other misconduct of the Chartered Accountants Act, 1949. As per Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he, in the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work. Here the Chartered Accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards calls for disciplinary action.

In the present case, YKS & Co, being a concurrent auditor, used his position to obtain the funds and failed to repay the same to the bank. This brings disrepute to the profession of a Chartered Accountant. This act of YKS & Co is not pardonable.

Conclusion: Therefore, YKS & Co will be held guilty of other misconduct under Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949.

These Clauses (1) & (2) are self-explanatory and any of the member of the Institute is found guilty by any civil or criminal court and prosecuted for an imprisonment in an offence involving moral turpitude or his acts bring disrepute to the profession or the Institute, irrespective of the fact whether such acts are related to profession or not, such member will be deemed to be guilty of other misconduct in Part IV of First Schedule.

The important point to note is that if imprisonment tenure exceeds six months, this case will be covered in the Clause of Part III of Second Schedule.

8.2 The Second Schedule

Where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the second schedule or in both the Schedule, he shall place the matter before the Disciplinary Committee.

Part I - Professional Misconduct in relation to Chartered Accountants in Practice

A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he-

Clause (1) Discloses Information acquired in the course of his professional engagement to any person other than his client so engaging him without the consent of his client or otherwise than as required by any law for the time being in force.

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An accountant in public practice has access to a great deal of information of his client, which is of a highly confidential character. It is important for the work of an accountant and for maintaining the dignity and status of the profession that he should treat such information as having been provided to him, only to facilitate the performance of his professional duties for which his services have been engaged. To divulge such information would be a breach of professional confidence, which may give rise to the most serious consequences, even to an action by the client for the loss suffered by him through such a breach. The accountant's duty not to disclose continues even after the completion of his assignment.

If disclosure is required as a part of performance of professional duty by a practicing member in relation to a client, the fact that such performance is required by the client would itself amount to the client consenting to such disclosure. Thus, a member in practice submitting information to, say, exchange control authorities, while performing his professional duties cannot be considered to have made disclosure without the aforesaid consent. But, in all cases, the request or the initiative that the members does prefer the service, which would entail such disclosure, must come from the client in relation to whose affairs the disclosure would be entailed.

If disclosure is required in other cases, it would be necessary to ensure that the consent of the client is given by a person who is competent to accord such consent. Thus, in the case of a sole proprietary concern, the consent may be given by the proprietor or his constituted attorney who is legally empowered to give such consent. In the case of partnership firm, since in turn, every partner has the authority to bind the firm by his acts, the consent may be given by any partner. In the case of a company, by virtue of section 179 of the Companies Act, 2013, the Board of Directors is empowered to do all that the company in a general meeting may do unless a resolution by the company in general meeting is required by the Act or by the Memorandum or Articles of the company. Hence, the consent may be sought from the Managing Director if the powers of the Board of Directors are delegated to him comprehensively enough to include the power to give such consent, but if the powers of the Board of Directors are not so delegated, the consent should be obtained by means of resolution of the Board of Directors of the Company.

An auditor is not required to provide the client or other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor. For this purpose, the term 'auditor' includes 'internal auditor'.

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However, the auditor may, at his discretion, in cases considered appropriate by him, make portions of or extracts from his working papers available to the client.

There is a difference between sharing of working papers and sharing of information. So far as the information is concerned, he can provide the same to the client or to a Regulatory body after obtaining the consent of the client.

It is not possible to set out all the circumstances under which disclosure of information may be required by law. If under any legal compulsion and if it is not legally permissible to claim privilege under the Evidence Act, 1872 (Section 126), the disclosure made by a member of such information may not be considered as misconduct. However, such matters involve niceties of law and expert legal advice may be sought prior to such disclosure.

The only circumstance in which this duty of confidence may give rise to a difficulty is where the accountant has reason to believe that the client has been guilty of some unlawful act or default. This matter is of special significance in the case where the client is guilty of tax evasion.

Further, students may note that as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Illustration 29

Mr. P, a Chartered Accountant was invited by the Chamber of Commerce to present a paper in a symposium on the issues facing Indian Leather Industry. During the course of his presentation, he shared some of the vital information of his client's business under the impression that it will help the Nation to compete with other countries at international level.

Disclosure of Client's Information: Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 deals with the professional misconduct relating to the disclosure of information by a chartered accountant in practice relating to the business of his clients to any person other than his client without the consent of his client or otherwise than as required by any law for the time being in force would amount to breach of conduct. The Code of Ethics further clarifies that such a duty continues even after completion of the assignment. The Chartered Accountant may however, disclose the information in case it is required as a part of performance of his professional duties. In the given case, Mr. Ph has disclosed vital information of his client's business without the consent of the client under the impression that it will help the nation to compete with other countries at International level.

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Conclusion: Thus, it is a professional misconduct covered by Clause (1) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Clause (2) Certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice.

The above clause restrains a member from subscribing to the report on a financial statement so long as it has not been examined by him or by a partner or an employee of his firm or by another chartered accountant in practice. It has been introduced to ensure that the work entrusted to him has been carried out by the member either directly or under his supervision before he renders his report.

An exception however has been made in respect of an examination carried out by another chartered accountant in practice. This enables two or more members to accept a joint assignment or enables a member also to carry out the examination of financial statements by or with the assistance of all or either any chartered accountant in practice.

Where the joint auditors are appointed, the work is normally divided among themselves in terms of identifiable units or areas, or with reference to the items of liabilities, or income or expenditure or to the period of time etc. Such division should be adequately documented and communicated to the auditee.

In the course of his work, where a joint auditor comes across matters requiring discussion with or application of judgement by the joint auditors, he must communicate to the other joint auditors before submission of the report.

In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible in accordance with SA 299 “Joint Audit of Financial Statements”:

Each joint auditor should decide for himself the appropriateness of using test checks or sampling, the nature, timing and extent of audit procedures to be applied in relation to the work allotted to him.

Obtaining and evaluating the information and explanations from the management is the joint responsibility of the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In case of distribution of the responsibility, the liability of the joint auditors is limited to the area allotted to that auditor.

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Clause (3) Permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast.

As per the opinion of the Council while finalising the Guidance Note on Accountant's Report on Profit Forecasts and/or Financial Forecasts at its 100th meeting held on 22nd through 24th July 1982, a chartered accountant can participate in the preparation of profit or financial forecasts and can review them, provided he indicates clearly in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and so long as he does not vouch for the accuracy of the forecasts. The Council has further opined that the same opinion would also apply to projections made on the basis of hypothetical assumptions about future events and management actions which are not necessarily expected to take place so long as the auditor does not vouch for the accuracy of the projection.

Further, the attention of the members is drawn to **"Guidance Note on Reports in Company Prospectuses (Revised 2019)"** issued by the Council in January 2019. This Guidance Note provides guidance on compliance with the provisions of the Companies Act, 2013 and the **Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations 2018** relating to the reports required to be issued by chartered accountants in prospectus issued by the companies for the offerings made in India.

A Chartered Accountant issued 97 Projection Statements for certain Individuals without verifying the basic documents and on the basis of which the Bank had extended the loan amount. Afterwards, the Bank revealed that persons for whom the Respondent had issued Financial Statements did not have any business/source for repayment of loan. Accordingly, Chartered Accountant will be held, guilty of professional misconduct falling within the meaning of Clauses (3), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

Clause (4) Expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.

(i) If the opinions of auditors are to command respect and the confidence of the public, it is essential that it must be free of any interest which is likely to affect their independence. Since financial interest in the business can be a substantial interest and one of the important factors which may disturb independence, the existence of such an interest direct or indirect affects the opinion of the auditors. As per this clause, an auditor should not express his opinion on financial statements of any business or enterprise wherein he has a substantial interest. This is intended to assure the public as regards the faith and confidences that could be reposed on the independent opinion expressed by the auditors.

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(ii) For the purpose of this Clause, the expression "Substantial Interest" shall have meaning as is assigned thereto, under Appendix (9) of the Chartered Accountants Regulations, 1988. (**see Clause 11 of Part I of First Schedule**).

(iii) The words "financial statements" used in this clause would cover both reports and certificates usually given after an examination of the accounts or the financial statement or any attest function under any statutory enactment or for purposes of income-tax assessments. This would not, however, apply to cases where such statements are prepared by members in employment purely for the information of their respective employers in the normal course of their duties and not meant to be submitted to any outside authority.

(iv) Public conscience is expected to be ahead of the law. Members, therefore, are expected to interpret the requirement as regards independence much more strictly than what the law requires and should not place themselves in positions which would either compromise or jeopardise their independence.

(v) Member must take care to see that they do not land themselves in situations where there could be conflict of interest and duty.



6. For example, where a Chartered Accountant is appointed the Liquidator of a Company, he should not qua a Chartered Accountant himself, audit the Statement of Accounts to be filed under Section 348(1) of the Companies Act, 2013. The audit in such circumstances should be done by a Chartered Accountant other than the one who is the Liquidator of the Company.

(vi) In this connection, the Council has decided not to permit a Chartered Accountant in employment to certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he holds certificate of practice and that such certification can be done by any Chartered Accountant in practice. This restriction would not however apply where the certification is permitted by any law. The Council has also decided that a Chartered Accountant should not by himself or in his firm name:-

a. accept the Auditorship of a college, if he is working as a part-time lecturer in the college.

b. accept the Auditorship of a Trust where his partner is either an employee or a trustee of the Trust.

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The Council has, in this connection, issued the following guidelines:

Requirements of Clause applicable to all Attest Functions

(vii) Many new areas of professional work have been added, e.g., Tax Audit, GST Audit, Concurrent Audit of Banks, Concurrent Audit of Borrowers of Financial institutions, Audit of non-corporate borrowers of Banks and Financial Institutions, Audit of Stock Exchange, Brokers, etc. The Council wishes to emphasize that the aforesaid requirement of Clause (4) are equally applicable while performing all types of attest functions by the members.

(viii) Some of the situations which may arise in the applicability of Clause (4) read with the definition of "Substantial Interest" (**see Clause 11 of Part I of First Schedule**).and other statutory prohibitions are discussed below for the guidance of members:-

1. Where the member, his firm or his partner or his relative has substantial interest in the business or enterprise (not being a company).

   The independence of mind is a fundamental concept of audit and/or expression of opinion on the financial statements in any form and, therefore, must always be maintained. Nothing can substitute for the essential and fundamental requirements of independence. Therefore, the Council's views are clarified in the following circumstances.

   (a) An enterprise/concern of which a member is either an owner or a partner

   The holding of interest in the business or enterprise (not being a company) by a member himself whether as sole-proprietor or partner in a firm, in the opinion of the Council, would affect his independence of mind in the performance of professional duties in conducting the audit and/or expressing an opinion on financial statements of such enterprise. Therefore, a member shall not audit financial statements of such business or enterprise.

   (b) Where the partner or relative of a member has substantial interest

   The holding of substantial interest by the partner or relative of the member in the business or enterprise (not being a company) of which the audit is to be carried out and opinion is to be expressed on the financial statement, may also affect the independence of mind of the member, in the opinion of Council, in the performance of professional duties. Therefore, the member may, for the same reasons as not to compromise his independence, desist from undertaking the audit of financial statements of such business or enterprise.

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2. Where the member or his partner or relative is a director or in the employment of an Officer or an Employee of the Company.

(a) Where the member is holding a position in the Company as Director, officer or employee

Section 141(3)(b) of the Companies Act, 2013 specifically prohibits a member from auditing the accounts of a Company in which he is an officer or employee of the Company, or in the employment of an officer or an employee of the Company (irrespective of the question of substantial interest).

Moreover, in case the member who is Director Simplicitor (general permission) in a Company, the Council has prohibited such member from auditing the accounts of a Company, whether or not he holds substantial interest in the Company.

In case the member seeks specific permission of the Council to be Whole Time or Managing Director in a Company, he would, on grant of such permission, not be entitled either to engage in attest functions (which includes audit), or to hold substantial interest in the Company. Although the provisions of the aforesaid section are not specifically applicable in the context of audits performed under other statutes, e.g. Tax Audit, yet the underlying principle of independence of mind is equally applicable in those situations also.

(b) Where the member is not holding a position in the Company, but holding any security or interest

Section 141(3) (d)(i) of the Companies Act, 2013 disqualifies a person from being Auditor of a Company, if he holds any security or interest in the Company, or its subsidiary, or holding or associate company or a subsidiary of such holding Company.

(c) Where the partner of the member is an officer or employee of a company

Section 141(3)(c) of the Companies Act, 2013 disqualifies a member from being the auditor of a Company, where the partner of such member is an officer or employee of the Company.

(d) Where the partner of the member is holding any security or interest in the Company

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Section 141(3) (d)(i) of the Companies Act, 2013 bars a person from being auditor of a Company, if his partner holds any security or interest in the Company, or its subsidiary, or holding or associate company or a subsidiary of such holding Company.

(e) Where the relative of the member is a director or is in the employment of the Company as a director or key managerial person

Section 141 (3) (f) of the Companies Act, 2013 bars a person from accepting audit of a Company where the relative of the member is director or is in the employment of the Company as a director or key managerial person.

(f) Where the relative of the member is holding any security or interest in the Company

Section 141(3)(d) (i) of the Companies Act, 2013, read with Rule 10 of Companies (Audit and Auditors) Rules, 2014 bars a person from being auditor of a Company, if his relative holds security or interest in the Company, or its subsidiary, or holding or associate company or a subsidiary of such holding Company of face value exceeding Rupees One Lakh.

(ix) It is not permissible for a member to undertake the assignment of certification, wherein the client is relative of the member. The "relative" for this purpose would refer to the definition mentioned in Accounting Standard (AS)-18.

(x) An accountant is expected to be no less independent in the discharge of his duties as a tax consultant or as a financial adviser than as auditor. In fact, it is necessary that he should bear the same degree of integrity and independence of mind in all spheres of his work. Unless this is done, the accounts of entities audited by Chartered Accountants or statements made by them during the course of assessment proceedings would not be relied upon as correct by the authorities.

(xi) **Members not to write Books of Account for auditee clients:** The Council has clarified that the members are not permitted to write the books of account of their auditee clients.

(xii) **Statutory auditor not to be the Internal Auditor simultaneously**: An Auditor appointed by an entity under the Companies Act or any other statute shall not be the Internal Auditor of the same entity.

(xiii) **Internal auditor not to be the Tax auditor simultaneously:** An Internal Auditor of an assessee, whether working with the organization or an independently practicing Chartered

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Accountant irrespective of being an individual Chartered Accountant or a firm of Chartered Accountants cannot be appointed as its Tax Auditor.

(xiv) **Internal Auditor not to be the GST Auditor simultaneously:** The Internal Auditor of an entity cannot undertake GST Audit of the same entity.

(xv) **Cooling off period after completion of tenure as Director:** A member shall not accept the assignment of audit of a Company for a period of two years from the date of completion of his tenure as Director, or resignation as Director of the said Company.

(xvi) **Members to satisfy whether appointment is as per the statute:** A member should satisfy himself before accepting an appointment as an auditor of an entity that his appointment is in accordance with the statute governing the entity. In case the entity is constituted under a trust deed/instrument, the member should satisfy whether his appointment is valid according to the instrument constituting the entity and rules and regulations made thereunder.

(xvii) In case the appointment is to be authorised by the regulatory authorities such as in the case of co-operative societies, trusts etc. then the member must satisfy whether such regulatory authorities have authorised the managing committee of the society/trust for appointment of the auditors. In a case where any entity is being managed by a Managing Committee or Board of Trustees or Board of Governors by whatever name called he should ensure that his appointment is duly made by a resolution passed of such Managing Committee or Board of Trustees or Board of Governors. Even in case of partnership or sole proprietary concerns, the member must ensure that a letter of appointment/engagement is given by the firm/sole proprietor before he accepts the appointment/ engagement.

(xviii) Section 288 of Income-tax Act, 1961 describe the disqualifications for the purpose of Tax Audit.

Clause (5) fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.

It may be observed that this clause refers to failure to disclose a material fact, which is known to him, in a financial statement reported on by the auditor. It is obvious, that before a member could be held guilty of misconduct, materiality has to be established. The determination of materiality has been provided in SA 320, “Materiality in Planning and Performing an Audit”.

It should be borne in mind that there may be cases where an item may not be material from the point of view of the balance sheet, but may have material significance in relation to the profit and loss account for that year and vice-versa. It is therefore essential that care should be taken to ensure

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that the aspect of materiality should be judged in relation to both the balance sheet and the profit and loss account.

The word "financial statements" used in this clause would cover both reports and certificate usually given after an examination of the accounts or of financial statements under any statutory enactment, or/for purposes of income tax assessments. This would not however, apply to cases where such statements are prepared by members in employment purely for the information of their respective employers in the normal course of their duties and not meant to be submitted to any outside authority.

Illustration 30

Mr. J, a Chartered Accountant during the course of audit of M/s XYZ Ltd. came to know that the company has taken a loan of ₹ 10 lakhs from Employees Provident Fund. The said loan was not reflected in the books of account. However, the auditor ignored this information in his report.

Failure to Disclose Material Facts: As per Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered Accountant in practice will be held liable for misconduct if he fails to disclose a material fact known to him, which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading. In this case, Mr. J has come across information that a loan of ₹ 10 lakhs has been taken by the company from Employees Provident Fund. This is contravention of Rules and the said loan has not been reflected in the books of accounts. Further, this material fact has also to be disclosed in the financial statements. The very fact that Mr. J has failed to disclose this fact in his report, he is attracted by the provisions of professional misconduct under Clause (5).

Conclusion: Mr. J will be liable of professional misconduct under Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Clause (6) Fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

This clause refers to failure on the part of a member to point out in his report a material misstatement appearing in a financial statement and he has knowledge of the same. Here also, it is obvious, that before a member could be held guilty of misconduct, materiality has to be established and the observations made under the preceding Clause (5), in this connection, will equally apply to this clause.

Illustration 31

A practicing Chartered Accountant was appointed to represent a company before the tax authorities. He submitted certain information and explanations to the authorities on behalf of his clients, which were found to be false and misleading.

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Submitting Information as Authorised Representative: As per Clause (5) of Part I of Second Schedule to the Chartered Accountant Act, 1949, if a member in practice fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading, where he is concerned with that financial statement in a professional capacity, he will be held guilty under Clause (5). As per Clause (6) of Part I of Second Schedule if he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity, he will be held guilty under Clause (6).

In given case, the Chartered Accountant had submitted the statements before the taxation authorities. These statements are based on the data provided by the management of the company. Although the statements prepared were based on incorrect facts and misleading, the Chartered Accountant had only submitted them acting on the instructions of his client as his authorized representative.

Conclusion: Hence, the Chartered Accountant would not be held liable for professional misconduct.

Clause (7) does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

Though very simply worded, it is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence. The meaning and significance of this clause is well contained in the following passage quoted from the Judgement of the Karnataka High Court in a disciplinary case which came before it in 1977:

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog but not a bloodhound. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful."

Professional misconduct is a term of fairly wide import but generally speaking, it implies fairly serious cases of misconduct of gross negligence. Negligence per se would not amount to gross negligence in the case of minor errors and lapses, which do not constitute professional misconduct and which, therefore, don't require a reference to the Disciplinary Committee, the Council would nevertheless bring the matter to the attention of its members so that greater care may be taken in the future in avoiding errors and lapses of a similar type.

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Illustration 32

CA C who conducted statutory audit of a Haryana daily 'New Era' certified the circulation figures based on Management Information System Report (M.I.S Report) without examining the books of Account.

Failed to exercise Due Diligence: According to Clause (7) of Part I of Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he "does not exercise due diligence or is grossly negligent in the conduct of his professional duties".

In the instant case, CA C did not exercise due diligence and is grossly negligent in the conduct of his professional duties since he certified the circulation figures without examining the books of accounts.

To ascertain the number of paid copies verification of remittances from the agents, credit allowed to the agents for unsold copies returned, examination of books of account is essential. Further certification of circulation figures based on statistical information without cross verification with financial records amounts to gross negligence and failure to exercise due diligence.

Conclusion: Hence, CA C is guilty of professional misconduct as per Clause (7) of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Illustration 33

Mr. D, a practicing Chartered Accountant, did not complete his work relating to the audit of the accounts of a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirements.

Not Exercising Due Diligence: According to Clause (7) of Part I of Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

It is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence.

Where a Chartered Accountant had not completed his work relating to the audit of the accounts a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirement in this regard. He was guilty of professional misconduct under Clause (7).

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Since Mr. D has not completed his audit work in time and consequently could not submit audit report in due time and consequently, company could not comply with the statutory requirements.

Conclusion: Therefore, the auditor is guilty of professional misconduct under Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

Clause (8): Fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.

It is expected of a Chartered Accountant to express his opinion on the truth and fairness of statements of accounts after examining their authenticity with reference to information and explanations given to him. A Chartered Accountant must determine the extent of information, which, should be obtained by him before he expresses an opinion on the financial statements submitted to him for report.

The chartered accountant should not express an opinion before obtaining the required data and information. The latter part of the clause enjoins that where due to inadequacy of information or data the report has to be circumscribed to an extent that it would cease to be of any expression of a categorical opinion, the auditor should clearly express his disclaimer in no uncertain terms.



7. For example, if the auditor has not seen any evidence of the existence and/or valuation of the investment which constitute the only asset of a company, he should not say that:

"Subject to the verification of the existence and value of the investments the balance sheet shows a true and fair view etc."

For manner of auditor's reporting in such situations, reference may be made to SA 705(Revised), "Modifications to the Opinion in the Independent Auditor's Report".

Where a Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e. by not looking into the financial records, bank statements or bank pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for. Held he was guilty under Clause (8). *[Registrar of Newspapers for India vs K. Rajinder Singh (1971)]*

"a certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion." A Chartered Accountant is required to clearly state his limitations/assumptions in his certificates, while in the said matter, the Respondent in none of the 12 certificates either mentioned his limitation or assumptions. Though, in his written

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statements he submitted that his job was not to verify the assets physically or verification of original bills or whether promoters contribution have come in actually in the Bank account etc. If his assignment did not include the same, he ought to have disclosed or mentioned in the certificates that while issuing the certificate he had relied upon the following documents, so as not to mislead the users of the said certificate(s). In the instant matter, the Respondent did not disclose any assumptions/limitations whatsoever while issuing the certificates. Moreover, the Respondent in none of the certificates issued by him had mentioned the basis/papers relied upon by him. Consequently, the same misled the IDBI Bank in approving the loan based on such certificates which did not mention the basis of issuance.

The Respondent while issuing the Certificates ought to have exercised diligence but he failed to do so. Accordingly, the Committee is of the view that the Respondent was grossly negligent in conduct of his professional duties and also failed to obtain sufficient information while issuing the aforestated certificates. Thus, he was guilty under clause (7) and (8).

The Committee noted that since the transaction of land took place between the Shivdarshan Firm i.e., a partnership firm and Siddheshwari Developers, the same should have been reflected in the books of Shivdarshan Firm and not in the books of Shivdarshan Construction which was a proprietary concern. The Respondent being the auditor of Shivdarshan Construction failed to report the said discrepancy in his audit report. Since, the amount of loan was material and the Respondent failed to submit any evidence based on which he had chosen not to qualify the appearance of housing loan from Navsarjan Industrial Co. Op. Bank Ltd in the financial statements, hence, the Committee is of the view that the Respondent is guilty of professional misconduct falling within the meaning of Clauses (6), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 *[Shri Mukesh M. Kelawala vs. CA Sukhdev Manilal Soni (2013)]*

Where the Respondent had failed to report on the Bank Account which was opened by the client in the capacity as a proprietor which included lot of variations, i.e., Account Number was different and the capacity in which Account was opened was also different. As a Professional, the Respondent ought to have copies of Bank Account which could easily establish the fact that the Bank Account was opened and operated proprietary name but he could not do that. Hence, it was observed that the Respondent was not only negligent in his duties in respect of auditing of bank transactions but also, failed to obtain sufficient information for expressing an opinion. The Respondent was held guilty of professional misconduct falling within the meaning of Clauses (7) & (8) of Part I of the Second Schedule to the Chartered Accountants Act 1949. *[P. Arun vs. N. Raja Ganesh, (2014)]*

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Illustration 34

Mr. A, a Chartered Accountant, was the auditor of 'A Limited'. During the financial year 2023-24, the investment appeared in the Balance Sheet of the company of ₹ 12 lakh and was the same amount as in the last year. Later on, it was found that the company's investments were only ₹ 25,000, but the value of investments was inflated for the purpose of obtaining higher amount of Bank loan.

Grossly Negligent in Conduct of Duties: As per Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he, certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice, under Clause (2); does not exercise due diligence, or is grossly negligent in the conduct of his professional duties, under Clause (7); or fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion, under Clause (8).

The primary duty of physical verification and valuation of investments is of the management. However, the auditor's duty is also to verify the physical existence and valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the Management's representation.

In the instant case, such non-verification happened for two years. It also appears that auditors failed to confirm the value of investments from any proper source. In case auditor has simply relied on the management's representation, the auditor has failed to perform his duty.

Conclusion: Accordingly, Mr. A, will be held liable for professional misconduct under Clauses (2), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

Clause (9) Fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

This clause implies that the audit should be performed in accordance with "generally accepted procedure of audit applicable to the circumstances" and if for any reason the auditor has not been able to perform the audit in accordance with such procedure, his report should draw attention to the material departures from such procedures. What constitutes "generally accepted audit procedure" would depend upon the facts and circumstances of each case, but guidance is available in general

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terms from the various pronouncements of the Institute is issued by way of Engagement and Quality Control Standards, Statements, General Clarifications, Guidance Notes Technical Guides, Practice Manuals, Studies and Other Papers. (ref.)

Audit of Listed Companies: Pursuant to SEBI Notification, Statutory Audit of Listed Companies under the Companies Act, 2013 shall be done by only those auditors who have subjected themselves to the Peer Review process of the Institute, and hold a valid certificate issued by the Peer Review Board of the ICAI.

FRN and Membership No.: The members are required to mention the Membership number and Firm registration number to all reports issued pursuant to any attestation engagements, including certificates, issued by them as proprietor of/ partner in the said firm.

Unique Document Identification Number (UDIN): The members may note that UDIN is mandatory from 1st July, 2019 on all Corporate/ Non- Corporate Audit, Attest and Assurance Functions. Thus, a member of the Institute in practice shall generate Unique Document Identification Number (UDIN) for all kinds of the certification, GST and Tax Audit Reports and other Audit, Assurance and Attestation functions undertaken/signed by him.

An auditor of a company is appointed by the shareholders to perform certain statutory functions and duties and it is expected of him that he will in fact, perform these functions and duties. The failure to perform a statutory duty in the manner required is not excused merely by giving a qualification or reservation in auditor's report.



8. For example, if an auditor fails to verify the cash balance in circumstances where such verification was necessary, feasible and material, it is not sufficient for him merely to state in his report that he did not verify the cash balance in circumstances when giving any reservations or qualifications in the auditor's report as required under this clause, a member would be well advised to indicate clearly the reasons why he was unable to perform the audit in accordance with generally accepted procedures and standards.

It is not possible to exhaustively deal with instances or accepted procedure of audit applicable to special cases. **Two instances** of an audit requiring a special procedure are given below:

Certifying figures of circulation of Newspapers etc.: Very often members are required to certify the figures of circulation of newspapers, magazines etc. by their clients on behalf of the Audit Bureau of Circulations Ltd. Members are normally supplied by the ABC with the Rules and Regulations under which the certification of circulation is to be carried out. Members are also asked to give their acceptance in writing that they will observe the rules of procedure envisaged to report upon any lapse of such special requirements, even of an insignificant nature.

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Verification on behalf of Banks: Similarly, in the case of verification on behalf of banks, the rules or procedure for conducting such audit are different from the normal rules applicable to audits under the Companies Act. Members are required to be very familiar with the special procedure required in these matters and act accordingly.

Clause (10) fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

In the course of his engagement as a professional accountant, a member may be entrusted with moneys belonging to his client. If he should receive such funds, it would be his duty to deposit them in a separate banking account, and to utilize such funds only in accordance with the instructions of the client or for the purposes intended by the client. In this connection the Council has considered some practical difficulties of the members and the following suggestions have been made to remove these difficulties:

(i) An advance received by a Chartered Accountant against services to be rendered does not fall under Clause (10) of Part I of the Second Schedule.

(ii) Moneys received for expenses to be incurred, for example, payment of prescribed statutory fees, purchase of stamp paper etc., which are intended to be spent within a reasonably short time need not be put in a separate bank account. For this purpose, the expression; "reasonably short time", would depend upon the circumstances of each case.

(iii) Moneys received for expenses to be incurred which are not intended to be spent within a reasonably short time as aforesaid, should be put in a separate bank account immediately.

(iv) Moneys received by a Chartered Accountant, in his capacity as trustee, executor liquidator, etc. must be put in a separate bank account immediately.

Illustration 35

A charitable institution entrusted ₹10 lakhs with its auditors M/s R & Co., a Chartered Accountant firm, to invest in a specified securities. The auditors deposited it in their Savings bank account and no investment was made in the next three months.

Failure to Keep Money in Separate Bank Account: If a Chartered Accountant in practice fails to keep moneys of his clients in a separate bank account or fails to use such moneys for purposes for which they are intended then his action would amount to professional misconduct under Clause (10) of Part I of Second Schedule to the Chartered Accountants Act, 1949. In the course of his engagement as a professional accountant, a member may be entrusted with moneys belonging to his client. If he should receive such funds, it would be his duty to deposit them in a separate

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banking account, and to utilise such funds only in accordance with the instructions of the client or for the purposes intended by the client.

Conclusion: In the given case by depositing the client's money by M/s R & Co., a firm of Chartered Accountants, in their own savings bank account, the auditors have committed professional misconduct. Hence in the given case, M/s R & Co. will be held guilty of professional misconduct.

PART II - Professional misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he -

Clause (1) contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

This clause is very important. It requires every member of the Institute to act within the framework of the Chartered Accountants Act and the Regulations and Guidelines made by Council thereunder. Any violation either of these Guidelines or the Act or the Regulations by a member would amount to misconduct under this part.

The Regulations under which cases of contravention have generally come to the notice of the Council are the following:

Regulation 43	Engagement of Articled Assistant
Regulation 46	Registration of Articled Assistant
Regulation 47	Premium from Articled Assistant
Regulation 48	Stipend to Articled Assistant
Regulation 56	Termination or assignment of Articles
Regulation 65	Articled Assistant not to engage in any other occupation
Regulation 67	Complaint against the employer (from Articled Assistant)
Regulation 68 to 80	Audit Assistant
Regulation 190	Register of offices and firms
Regulation 190-A	Chartered Accountants not to engage in any other business or occupation
Regulation 191	Part time employment's a Chartered Accountant may accept
Regulation 192	Restriction on fees

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Clause (2) being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer.

This is an adaptation of the well-accepted principle of the law of agency. A member in the forthcoming circumstance would be guilty of misconduct regardless of the fact that he was in whole time or part-time employment or that he was carrying on practice of accountancy along with his employment. Since as employee, a member may have access to a confidential information, hence for maintaining the status and dignity of the profession in general, he should treat such information as having been provided to him only to facilitate the performance of his duties as an employee. In order to keep the confidence of the people, Chartered Accountants, should take special care not to divulge such information.

Clause (3) includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline. Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

If a Chartered Accountant includes in any information, statement, return or form to be submitted to the Institute Council etc. any particular knowing it to be false, he will be held guilty of misconduct.

Where a Chartered Accountant who was employed as a manager of a firm of Registered Accountants, applied for admission as Fellow of the Institute stating that he was a partner, while he was not. Held that the Chartered Accountant was guilty of misconduct as he had made the statement that he was a partner knowing it to be false. *[J.R. Chatrath, (1952)]*

A Member had during the course of the hearing before Disciplinary Committee given a wrong statement duly verified and also a statement on oath knowing it to be false. He was found guilty in terms of this clause. *[K.S. Dugar, (1987)]*

In spite of repeated reminders a Chartered Accountant failed to reply to the letters of the Institute asking him to confirm the date of leaving the services by the Paid Assistant. Held, the Chartered Accountant was guilty of professional misconduct under the Clause. *[A. Umanath Rao, [1965)]*

Clause (4) defalcates or embezzles money received in his professional capacity.

Defalcation and embezzlement of moneys received in professional capacity amounts to fraud (Covered in SA-240) and such member will be deemed to be guilty of professional misconduct under this clause.

Clause (5) acts as an auditor of the company in contravention of the provisions of the Companies Act, 2013.

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Part III - Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

Imprisonment awarded for a term exceeding six months in any civil/criminal matter treated as a major offence under 'other misconduct' is included in this Schedule.

9 COUNCIL GUIDELINES

The relevant extracts of the **Council General Guidelines, 2008** ***(issued under Clause (1) of Part-II of Second Schedule to The Chartered Accountants Act, 1949) are given below:***

Chapter I

Preliminary

1.0 Short title, commencement, etc.

(a) These Guidelines have been issued by the Council of the Institute of Chartered Accountants of India under the provisions of The Chartered Accountants Act, 1949, as amended by The Chartered Accountants (Amendment) Act 2006, These Guidelines be called the 'Council General Guidelines, 2008'.

(b) These guidelines shall be applicable to all the Members of the Institute whether in practice or not wherever the context so requires.

Chapter II

Conduct of a Member being an employee

A member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

Chapter III

Appointment of a Member as Cost auditor

This Chapter is being omitted.

Chapter IV

Opinion on financial statements when there is substantial interest

This Chapter is being omitted.

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Chapter V

Maintenance of books of account

A member of the Institute in practice or the firm of Chartered Accountants of which he is a partner, shall maintain and keep in respect of his / its professional practice, proper books of account including the following-

(i) a Cash Book;

(ii) a Ledger.

Illustration 36

L, a chartered accountant did not maintain books of account for his professional earnings on the ground that his income is less than the limits prescribed u/s 44AA of the Income Tax Act, 1961.

Maintenance of Books of Account: As per the Council General Guidelines 2008, under Chapter 5 on maintenance of books of accounts, it is specified that if a chartered accountant in practice or the firm of Chartered Accountants of which he is a partner fails to maintain and keep in respect of his/its professional practice, proper books of account including the Cash Book and Ledger, he is deemed to be guilty of professional misconduct. Accordingly, it does not matter whether section 44AA of the Income Tax Act, 1961 applies or not.

Conclusion: Hence, Mr. L is guilty of professional misconduct.

Chapter VI

Tax Audit assignments under Section 44 AB of the Income-tax Act, 1961

A member of the Institute in practice shall not accept, in a financial year, more than the "specified number of tax audit assignments" under Section 44AB of the Income-tax Act, 1961.

Provided that in the case of a firm of Chartered Accountants in practice, the "specified number of tax audit assignments" shall be construed as the specified number of tax audit assignments for every partner of the firm.

Provided further that where any partner of the firm is also a partner of any other firm or firms of Chartered Accountants in practice, the number of tax audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the "specified number of tax audit assignments" in the aggregate.

Provided further that where any partner of a firm of Chartered Accountants in practice accepts one or more tax audit assignments in his individual capacity, the total number of such assignments which

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may be accepted by him shall not exceed the "specified number of tax audit assignments" in the aggregate.

Provided also that the audits conducted under Section 44AD, 44ADA[1] *and 44AE of the Income Tax Act, 1961 shall not be taken into account for the purpose of reckoning the "specified number of tax audit assignments".*

Explanation:

For the above purpose, "the specified number of tax audit assignments" means -

(a) in the case of a Chartered Accountant in practice or a proprietary firm of Chartered Accountant, **60 tax audit assignments, in a financial year, whether in respect of corporate or non-corporate assesses.

(b) in the case of firm of Chartered Accountants in practice, **60 tax audit assignments per partner in the firm, in a financial year, whether in respect of corporate or non-corporate assesses.

> According to a clarification on Tax Audit Assignments by Committee on Ethical Standards Board) of the Institute, if there are 10 partners in a firm of Chartered Accountants in practice, then all the partners of the firm can collectively sign 600 tax audit reports. This maximum limit of 600 tax audit assignments may be distributed between the partners in any manner whatsoever. For instance, 1 partner can individually sign 600 tax audit reports in case remaining 9 partners are not signing any tax audit report.

In computing the "specified number of tax audit assignments" each year's audit would be taken as a separate assignment.

In computing the "specified number of tax audit assignments", the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other Chartered Accountant in practice or firm of such Chartered Accountants, shall be taken into account.

The audit of the head office and branch offices of a concern shall be regarded as one tax audit assignment.

The audit of one or more branches of the same concern by one Chartered Accountant in practice shall be construed as only one tax audit assignment.

[1] As inserted by the Council pursuant to decision at its 368th Meeting held on 10th to 12th Aug., 2017 (Section 44AF, earlier appearing, was repealed).

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A Chartered Accountant being a part time practicing partner of a firm shall not be taken into account for the purpose of reckoning the tax audit assignments of the firm.

A Chartered Accountant in practice shall maintain a record of the tax audit assignments accepted by him in each assessment year in the format as may be prescribed by the Council.

The limit on number of tax audit assignments per partner in a CA Firm may be distributed between the partners in any manner whatsoever. However, it should be in accordance with the Standard on Quality Control (SQC) 1: Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

Illustration 37

A member of the institute shall not accept in a year more than the specified number of tax audits under section 44AB of the Income Tax Act.

Mr. G is a partner in M/s. XYZ & Co., a firm of Chartered Accountants with 6 partners.

During the assessment year 2023-24, Mr. G alone had signed 290 tax audit reports consisting of both corporate and non-corporate assesses.

Ceiling limit for signing the Tax Audit Reports: As per Council General Guidelines 2008, a member of the Institute in practice shall not accept, in a financial year, more than the "specified number of tax audit assignments" under Section 44AB of the Income-tax Act, 1961. It is also provided further that where any partner of a firm of Chartered Accountants in practice accepts one or more tax audit assignments in his individual capacity, the total number of such assignments which may be accepted by him shall not exceed the "specified number of tax audit assignments" in the aggregate.

In the case of firm of Chartered Accountants in practice "the specified number of tax audit assignments" means 60 tax audit assignments per partner in the firm, in a financial year, whether in respect of corporate or non-corporate assesses.

Further, as per clarification issued by the Institute on Tax Audit Assignments, tax audit reports may be signed by the partners in any manner whosoever in accordance with specified audit limits. Thus, one partner can individually sign all the tax audit reports subject to specified tax audit assignment limits on behalf of all the partners in the firm of Chartered Accountants in practice or all the partners of the firm can collectively sign the tax audit reports.

In the instant case, there are 6 partners in M/s XYZ & Co., a Chartered Accountants firm, accordingly, specified ceiling limit for the firm will be (60 tax audit assignments per partner X 6 partners) = 360. Therefore, all the 6 partners of the firm can collectively sign 360 tax audit reports. This maximum limit of 360 tax audit assignments may be distributed between the partners in any manner whatsoever. For instance, 1 partner can individually sign 360 tax audit

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reports in case remaining 5 partners are not signing any tax audit report.

Assuming Mr. G has signed 290 tax audit reports consisting of both corporate and non-corporate assesse on behalf of firm and remaining partners are signing audit reports within the specified number of tax audit assignments u/s 44AB i.e. upto 70.

Conclusion: Hence, Mr. G shall not be deemed to guilty of professional misconduct provided total number of tax audit reports on behalf of firm do not exceeds 360.

Chapter VII
Appointment of an Auditor in case of non-payment of undisputed fees

A member of the Institute in practice shall not accept the appointment as auditor of an entity in case the undisputed audit fee of another Chartered Accountant for carrying out the statutory audit under the Companies Act, 2013 or various other statutes has not been paid:

Provided that in the case of sick unit, the above prohibition of acceptance shall not apply.

Explanation 1: For this purpose, the provision for audit fee in accounts signed by both - the auditee and the auditor along with other expenses, if any, incurred by the auditor in connection with the audit, shall be considered as "undisputed audit fees".

Explanation 2: For this purpose, "sick unit" shall mean a unit registered for not less than five years, which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.

Illustration 38

Mr. C accepted the statutory audit of M/s PSU Ltd., whose net worth is negative for the year 2022-23. The audit was to be conducted for the year 2023-24. The audited accounts for the year 2023-24 showed liability for payment of tax audit fees of ₹15,000 in favour of Mr. E, the previous auditor.

Accepting Appointment as an Auditor: As per Chapter 7 of Council General Guidelines 2008, a member of the Institute of Chartered Accountants of India in practice shall be deemed to be guilty of professional misconduct if he accepts appointment as auditor of an entity in case the undisputed audit fee of another chartered accountant for carrying out the statutory audit under the Companies Act, 2013 or various other statutes has not been paid.

As per the proviso, such prohibition shall not apply in case of a sick unit where a sick unit is defined to mean "where the net worth is negative".

Conclusion: In the instant case, though the undisputed fees are unpaid, Mr. C would still not be guilty of professional misconduct since the M/s PSU Ltd. is a sick unit having negative net worth for the year 2022-23.

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Chapter VIII

Specified number of audit assignments

A member of the Institute in practice shall not hold at any time appointment of more than the "specified number of audit assignments" of Companies under Section 141 of the Companies Act 2013.

Provided that in the case of a firm of Chartered Accountants in practice, the "specified number of audit assignments" shall be construed as the specific number of audit assignments for every partner of the firm.

Provided further that where any partner of the firm of Chartered Accountants in practice is also a partner of any other firm or firms of Chartered Accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the "specified number of audit assignments" in the aggregate.

Provided further where any partner of a firm or firms of Chartered Accountants in practice accepts one or more audit of Companies in his individual capacity, or in the name of his proprietary firm, the total number of such assignments which may be accepted by all firms in relation to such Chartered Accountant and by him shall not exceed the "specified number of audit assignments" in the aggregate.

Explanation:

1. For the above purpose, the "specified number of audit assignments" means –

   (a) in the case of a Chartered Accountant in practice or a proprietary firm of Chartered Accountant, 30 audit assignments whether in respect of private Companies or other Companies, with the exception of one person Companies and dormant companies.

   (b) in the case of Chartered Accountants in practice, 30 audit assignments per partner in the firm, whether in respect of private Companies or other Companies, with the exception of One person Companies and dormant companies[2].

2. In computing the "specified number of audit assignments"-

   (a) the number of audit of such Companies, which he or any partner of his firm has accepted whether singly or in combination with any other Chartered Accountant in practice or firm of such Chartered Accountants, shall be taken into account.

[2] As incorporated pursuant to decision of Council at its 388th Meeting held on 6th and 7th Feb., 2020.

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(b) the audit of the head office and branch offices of a Company by one Chartered Accountant or firm of such Chartered Accountants in practice shall be regarded as one audit assignment.

(c) the audit of one or more branches of the same Company by one Chartered Accountant in practice or by firm of Chartered Accountants in practice in which he is a partner shall be construed as one audit assignment only.

(d) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.

A Chartered Accountant in practice, whether in full-time or part time employment elsewhere, shall not be counted for the purpose of determination of "specified number of audit of Companies" by firms of Chartered Accountants.

A Chartered Accountant being a part time practicing partner of a firm shall not be taken into account for the purpose of reckoning the audit assignments of the firm.

A Chartered Accountant in practice as well as firm of Chartered Accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of Chartered Accountants, or by any of the partners of the firm in his individual name or as a partner of any other firm, as far as possible in the prescribed format.

Chapter IX

Appointment as Statutory auditor

A member of the Institute in practice shall not accept the appointment as statutory auditor of Public Sector Undertaking(s)/ Government Company(ies)/Listed Company(ies) and other Public Company(ies) having turnover of ₹ 50 crores or more in a year where he accepts any other work(s) or assignment(s) or service(s) in regard to the same Undertaking(s)/ Company(ies) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same Undertaking/company.

Provided that in case appointing authority(ies)/regulatory body(ies) specify(ies) more stringent condition(s)/restriction(s), the same shall apply instead of the conditions/restrictions specified under these Guidelines.

The above restrictions shall apply in respect of fees for other work(s) or service(s) or assignment(s) payable to the statutory auditors and their associate concern(s) put together.

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For the above purpose,

(i) the term "other work(s)" or "service(s)" or "assignment(s)" shall include Management Consultancy and all other professional services permitted by the Council pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 but shall not include:-

(a) audit under any other statute;

(b) certification work required to be done by the statutory auditors; and

(c) any representation before an authority;

(ii) the term "associate concern" means any corporate body or partnership firm which renders the Management Consultancy and all other professional services permitted by the Council wherein the proprietor and/or partner(s) of the statutory auditor firm and/or their "relative(s)" is/are Director/s or partner/s and/or jointly or severally hold "substantial interest" in the said corporate body or partnership;

(iii) the terms "relative" and "substantial interest" shall have the same meaning as are assigned thereto under Appendix (9) to the Chartered Accountants Regulations, 1988.

In regard to taking up other work(s) or service(s) or assignment(s) of the undertaking/company referred to above, it shall be open to such associate concern or corporate body to render such work(s) or service(s) or assignment(s) so long as aggregate remuneration for such other work(s) or service(s) or assignment(s) payable to the statutory auditor/s together with fees payable to its associate concern(s) or corporate body(ies) do/does not exceed the aggregate of fee payable for carrying out the statutory audit.

Illustration 39

A is the auditor of Z Ltd., which has a turnover of ₹ 200 crore. The audit fee for the year is fixed at ₹ 50 lakhs. During the year, the company offers A an assignment of management consultancy within the meaning of Section 2(2)(iv) of the CA Act, 1949 for a remuneration of ₹ 1 crore. A seeks your advice on accepting the assignment.

Appointment as a Statutory Auditor of a PSUs'/Govt Company(ies)/Listed Company(ies) and Other Public Company(ies): As per the Council General Guidelines 2008, under Chapter IX on appointment as statutory auditor a member of the Institute in practice shall not accepts the appointment as a statutory auditor of a PSUs'/Govt company(ies)/Listed company(ies) and other public company(ies) having a turnover of ₹ 50 crores or more in a year and where he accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the

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same undertaking. For this purpose, the other work/services include Management Consultancy and all other professional services permitted by Council excluding audit under any other statute, Certification work required to be done by the statutory auditor and any representation before an authority.

Conclusion: In view of the above provision, it would be a misconduct on A's part if he accepts the management consultancy assignment for a fee of ₹ 1 crore.

Chapter X
Appointment of an auditor when he is indebted to a concern

A member of the Institute in practice or a partner of a firm in practice or a firm or a relative of such member or partner shall not accept appointment as auditor of a concern while indebted to the concern or given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding ₹ 100,000/-.

Illustration 40

D, who conducts the tax audit u/s 44AB of the Income Tax Act, 1961 of M/s ABC, a partnership firm, has received the audit fees of ₹ 2,50,000 on progressive basis in respect of the tax audit for the year ended 31.3.2024. The audit report was, however, signed on 25.5.2024.

Entire Audit Fees Received in Advance: As per Chapter X of Council General Guidelines, 2008 a member of the Institute in practice or a partner of a firm in practice or a firm shall not accept appointment as auditor of a concern while indebted to the concern or given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding ₹ 1,00,000/-.

However, the Research Committee of the ICAI has expressed the opinion that where in accordance with the terms of engagement of auditor by a client, the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job, he cannot be said to be indebted to the company at any stage.

Conclusion: In the instant case, Mr. D is appointed to conduct a tax audit u/s 44AB of the Income Tax Act, 1961. He has received the audit fees of ₹ 2,50,000 in respect of the tax audit for the year ended 31.3.2024 which is on a progressive basis. Therefore, Mr. D will not be held guilty for misconduct.

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Chapter XI
Directions in case of unjustified removal of auditors

A member of the Institute in practice shall follow the direction given, by the Council or an appropriate Committee or on behalf of any of them, to him being the incoming auditor(s) not to accept the appointment as auditor(s), in the case of unjustified removal of the earlier auditor(s).

Chapter XIII
Guidelines on Tenders

A member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for chartered accountants, such as audit and attestation services. However, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.

Chapter XIV
Unique Document Identification Number (UDIN) Guidelines

Whereas, to curb the malpractice of false certification/attestation by the unauthorized persons & to eradicate the practice of bogus certificates and to save various regulators, banks, stakeholders etc. from being misled, the Council of the Institute decided to implement an innovative concept to generate Unique Document Identification Number (UDIN) mandatorily for all kinds of the certificates/GST and Tax Audit Reports and other attest function in phased manner, for which members of the ICAI were notified through the various announcements published on the website of ICAI www.icai.org at the relevant times.

A member of the Institute in practice shall generate Unique Document Identification Number (UDIN) for all kinds of the certification, GST and Tax Audit Reports and other Audit, Assurance and Attestation functions undertaken/signed by him which made mandatory from the following dates through announcements published on the website of the ICAI www.icai.org at the relevant time: -

- For all Certificates w.e.f. 1st February, 2019.
- For all GST and Tax Audit Reports w.e.f. 1st April, 2019.
- For all other Audit, Assurance and Attestation functions w.e.f. 1st July, 2019.

Chapter XV
Guidelines for Networking

Concept: To enhance their ability to provide professional services, firms frequently form larger structures with other firms and entities. Whether these larger structures create a network depends

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on the particular facts and circumstances and does not depend on whether the firms and entities are legally separate and distinct.

For example, a larger structure may be aimed only at facilitating the referral of work, which in itself does not meet the criteria necessary to constitute a network. Alternatively, a larger structure might be such that it is aimed at co-operation and the firms share a common brand name, a common system of quality control, or significant professional resources and consequently is deemed to be a network.

The judgment as to whether the larger structure is a network shall be made in light of whether a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that the entities are associated in such a way that a network exists. This judgment shall be applied consistently throughout the network.

Where the larger structure is aimed at co-operation and it is clearly aimed at profit or cost sharing among the entities within the structure, it is deemed to be a network. However, the sharing of immaterial costs does not in itself create a network. In addition, if the sharing of costs is limited only to those costs related to the development of audit methodologies, manuals, or training courses, this would not in itself create a network. Further, an association between a firm and an otherwise unrelated entity to jointly provide a service or develop a product does not in itself create a network.

Where the larger structure is aimed at cooperation and the entities within the structure share common ownership, control or management, it is deemed to be a network. This could be achieved by contract or other means.

Where the larger structure is aimed at co-operation and the entities within the structure share common quality control policies and procedures, it is deemed to be a network. For this purpose, common quality control policies and procedures are those designed, implemented and monitored across the larger structure.

Where the larger structure is aimed at co-operation and the entities within the structure share a common business strategy, it is deemed to be a network. Sharing a common business strategy involves an agreement by the entities to achieve common strategic objectives. An entity is not deemed to be a network firm merely because it co- operates with another entity solely to respond jointly to a request for a proposal for the provision.

Where the larger structure is aimed at co-operation and the entities within the structure share the use of a common brand name, it is deemed to be a network. A common brand name includes common initials or a common name. A firm is deemed to be using a common brand name if it

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includes, for example, the common brand name as part of, or along with, its firm name, when a partner of the firm signs an audit report.

Even though a firm does not belong to a network and does not use a common brand name as part of its firm name, it may give the appearance that it belongs to a network if it makes reference in its stationery or promotional materials to being a member of an association of firms. Accordingly, if care is not taken in how a firm describes such memberships, a perception may be created that the firm belongs to a network.

Where the larger structure is aimed at co-operation and the entities within the structure share a significant part of professional resources, it is deemed to be a network. **Professional resources include:**

- Common systems that enable firms to exchange information such as client data, billing and time records;
- Partners and staff;
- Technical departments that consult on technical or industry specific issues, transactions or events for assurance engagements;
- Audit methodology or audit manuals; and
- Training courses and facilities.

The determination of whether the professional resources shared are significant, and therefore the firms are network firms, shall be made based on the relevant facts and circumstances. Where the shared resources are limited to common audit methodology or audit manuals, with no exchange of personnel or client or market information, it is unlikely that the shared resources would be significant. The same applies to a common training endeavor. Where, however, the shared resources involve the exchange of people or information, such as where staff are drawn from a shared pool, or a common technical department is created within the larger structure to provide participating firms with technical advice that the firms are required to follow, a reasonable and informed third party is more likely to conclude that the shared resources are significant.

Forms of the Network :

The different forms of Network can be as under:-

A network can be constituted as a mutual entity which will act as a facilitator for the constituents of the Network. In such a case the Network itself will not carry out any professional practice.

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A network can be constituted as a partnership firm subject to the condition that the total number of partners does not exceed twenty.

A network can be constituted as a Limited Liability Partnership subject to the provision of the Chartered Accountant Act and Rules and such other laws as may be applicable.

A network can be constituted as company subject to the guidelines prescribed by Institute for corporate form of practice and formation of management consultancy services company.

Network Firms shall consist of sole Practitioner/proprietor, partnership or any such entity of professional accountants as may be permitted by the Act.

A firm is allowed to join only one network.

Firms having common partners shall join only one Network.

Approval of Name of Network amongst firms registered with Institute:

1. The Network may have distinct name which should be approved by the Institute. To distinguish a "Network" from a "firm" of Chartered Accountants, the words "& Affiliates" shall be used after the name of the network and the words "& Co." / "& Associates" shall not be used. The prescribed format of application for approval of Name for Network is at Form 'A' (enclosed). The names of the network may be as mentioned in Appendix II.

2. Provisions of Regulation 190 of the Chartered Accountants Regulations, 1988 shall be applicable to the name of Network. However, even if a name is approved and subsequently it is found that the same is undesirable then, the said name may be withdrawn at any time by the Institute. The Institute shall reject any undesirable name and the provisions in respect of names of companies as prescribed in the Companies Act, 1956 shall be applicable in spirit.

3. The Institute shall approve or reject the name of the Network and intimate the same to the Network at its address mentioned in Form 'A' within a period which shall not be later than 30 days from the date of receipt of the said Form.

4. Mere approval of the name of the Network shall not entitle the Network to carry on practice in its own name.

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Registration of Network with entities in India

1. **After the name of a Network is approved as per provision under Guideline 5, the Institute same shall reserve such name for a period of three (3) months from the date of approval.**
2. **The Network shall get itself registered with the Institute by applying in Form B within the period of 3 months, failing which the name assigned shall stand cancelled on the expiry of the said period.**
3. **Registration of Network with Institute is mandatory.**
4. **If different Indian firms are networked with a common Multinational Accounting Firm, they shall be considered as a part of network.**

Listing of Network with entities outside India

1. **The duly authorized representative(s) of the Indian Member firm (s)/Member constituting the Network with entities outside India shall file a declaration with the Institute in Form `D' for Listing of such Network within 30 days from the date of entering into the Network arrangement.**
2. **Proprietary/individual members, partnership firms as well as members in LLP or any such other entity of members as may be permitted by the Act, shall be permitted to join such network with entities outside India provided that the proprietary/individual members, partnership firms as well as members in LLP or any such other entity of members are allowed to join only one network and firms having common partners shall join only one such network.**

Change in constitution of registered Network:

In case of change in the constitution of registered Network on account of any entry into or exit from the Network, the network shall communicate the same to the Institute by filing Form 'C' within a period of thirty (30) days from the date of change in the constitution.

Ethical Compliance:

Once the relationship of network arises, it will be necessary for such a network to comply with all applicable ethical requirements prescribed by the Institute from time to time in general and the following requirements in particular: -

1. If one firm of the network is the statutory auditor of an entity then the associate [including the networked firm(s)] or the said firm directly/indirectly shall not accept the internal audit

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or book-keeping or such other professional assignments which are prohibited for the statutory auditor firm.

2. The guidelines of ceiling on Non-audit fees is applicable in relation to a Network as follows: -

   i) For a Network firm who is doing statutory audit (including its associate concern and/or firm(s) having common partnership), it shall be the same as mentioned in the said notification; and

   ii) For other firms of the same Network collectively, it shall be 3 times of the fee payable for carrying out the statutory audit of the same undertaking/ company.

3. In those cases where rotation of firms is prescribed by any regulatory authority, no member firm of the network can accept appointment as an auditor in place of any member firm of the network which is retiring.

4. The Network may advertise the Network to the extent permitted by the Advertisement Guidelines issued by Institute. The firms constituting the network are permitted to use the words "Network Firms" on their professional stationery.

5. The constituent member firms of a Network and the Network shall comply with all the Ethical Standards prescribed by the Council from time to time.

Consent of Client:

The effect of registration of network with Institute will be deemed to be a public notice of the network and therefore consent of client will be deemed to be obtained.

Framework of Internal Byelaws of Network:

To streamline the networking, a network shall formulate operational bye-laws. Bye-laws may contain the following clauses on which the affiliates of the network may enter into a written agreement among themselves:

(i) Appointment of a Managing Committee, from among the managing partners of the member firms of the network and the terms and conditions under which it should function. The minimum and maximum number of members of the Managing Committee shall also be agreed upon.

(ii) Administration of the network.

(iii) Contribution of membership fees to meet the cost of the administration of the network.

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(iv) Identifying a partner of any of the member firms of the network to be responsible for the assignment (engagement partner).

(v) Dispute settlement procedures through arbitration and conciliation.

(vi) Development of training materials for members of the network.

(vii) Issue of News-letters for staff and clients.

(viii) Development of software for different types of assignments.

(ix) Development and maintenance of data bases relevant for different types of assignments.

(x) Library.

(xi) Appointment of a technical director to whom references can be made.

(xii) Determining the methodology for drawing resources from each member firm.

(xiii) Determining compensation to member firms for resources to be drawn from them.

(xiv) Peer review of the member firms.

These clauses are illustrative.



9. Illustrative examples of names of Network: -

(a) If the Network is a Mutual Entity or Partnership Firm:

AB & Affiliates

(b) If the Network is a LLP:

AB Affiliates LLP

(c) If the Network is a Limited Company:

AB Affiliates P. Ltd/Limited

Chapter XVI

Logo Guidelines

Guidelines issued in 2023 for using the new CA India logo for CA members prescribes that the logo consists of the letters 'CA' in blue colour with a tri colour tick mark (upside down) with white background. The blue colour not only stands out on any background but also denotes creativity, innovativeness, knowledge, integrity, trust, truth, stability, and depth. The upside-down tick mark, typically used by Chartered Accountants, has been included to symbolise the wisdom and value of the professional.

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'India' is also added in the logo, as it epitomizes the Institute's connection to India First approach and commitment to the serve the Indian economy in public interest.

- *There should be no alteration of the font (colour, bold/unbold, size). Moreover, there should be no change in spacing and dimensions.*
- *The colour palette is*

#F37920
C0 M62 Y91 K0

#145886
C93 M61 Y24 K9

#55B848
C67 M0 Y88 K0

- *Do not change the design and colours including the white background.*
- *Refrain from rotating or tilting the logo clockwise and anti-clockwise.*
- *The logo should not be shrunk or distorted changing the original proportion.*

Note: While members are encouraged to use the new CA India Logo as published on letterheads, visiting cards, website etc, a transition time of one year has been provided to use existing stationary/signage replacement etc.



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Chapter XVII

Guidelines for Corporate Form of Practice

The Council decided to allow members in practice to hold the office of Managing Director, Whole-time Director or Manager of a body corporate within the meaning of the Companies Act provided that the body corporate is engaged exclusively in rendering Management Consultancy and Other Services permitted by the Council in pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 and complies with the conditions(s) as specified by the Council from time to time in this regard.

The members can retain full time Certificate of Practice besides being the Managing Director, Whole-time Director or Manager of such Management Consultancy Company. There will be no restriction on the quantum of the equity holding of the members, either individually and/ or along with the relatives, in such Company. Such members shall be regarded as being in full- time practice and therefore can continue to do attest function either in individual capacity or in Proprietorship/Partnership firm in which capacity they practice and wherein they are also entitled to train articled/audit assistants.

The name of the Management Consultancy Company is required to be approved by the Institute and such Company has to be registered with the Institute. The guidelines alongwith the prescribed application forms for approval of name and registration, provisions of ethical compliance and other details have been issued and the same will come into force w.e.f. 1.10.2006.

On abundant caution, it may be clarified that no audit practice can be done in Corporate Form. The consultancy practice hitherto done in Individual or Firm Status alone is now intended to be permitted in Corporate Form also.

Ethical Compliance: (i) Once the Management Consultancy Company is Registered with the Institute as per the Guidelines, it will be necessary for such a Company to comply with the following requirements: -

(a) If the individual practitioner/sole-proprietorship firm/partnership firm is the statutory auditor of an entity then the Management Consultancy Company should not accept the internal audit or book-keeping or such other professional assignments, which are prohibited for the statutory auditor firm.

(b) The Notification No. 1-CA(7)/60/2002 dated 8th March, 2002 (enclosed) in respect of ceiling on Non-audit fees is applicable in relation to a Management Consultancy Company.

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(c) The Management Consultancy Company shall comply with clauses (6) & (7) of Part-I of the First Schedule to the Chartered Accountants Act, 1949 and such other directives as may be issued by the Institute from time to time.

(ii) The Management Consultancy Company shall give an undertaking that it shall comply with clauses (6) & (7) of Part-I of the First Schedule to the Chartered Accountants Act, 1949 and such other directives as may be issued by the Institute from time to time.

Object of Management Consultancy Company: The Management Consultancy Company shall engage itself only in Management Consultancy & Other Services. The Management Consultancy Company shall give an undertaking that it shall render only Management Consultancy & Other Services prescribed by the Council pursuant to powers under section 2 (2)(iv) of the Chartered Accountants Act, 1949.

Note: Students are advised to refer Appendix 'D' of the Code for more details.

9.1 Council Guidelines for Advertisement, 2008

1. Write up -

The Members may advertise through a write up setting out their particulars or of their firms and services provided by them subject to the following Guidelines and must be presented in such a manner as to maintain the profession's good reputation, dignity and its ability to serve the public interest.

The Member(s)/Firm(s) should ensure that the contents of the Write up are true to the best of their knowledge and belief and are in conformity with these Guidelines and be aware that the Institute of Chartered Accountants of India will neither approve a propose write-up, nor owns any responsibility whatsoever for such contents or claims by the writer Member(s)/ Firm(s).

The write-up shall comply with the following conditions:-

A. It shall be honest and truthful.

B. There shall be no exaggerated claims for the services offered by the member or the Firm, or the qualifications or experience of the member or any of the partners or any other person associated with the Firm.

C. It must not make any disparaging references or unsubstantiated comparisons to the work of others.

D. It should not be of a nature that may bring the profession into disrepute.

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E. It should not contain testimonials or endorsements concerning Member(s) or names of clients (both the past and present) or the fees charged.

F. It should not contain any information about achievements /awards (except the awards given by the Central or State Governments or Regulatory bodies) or any other position held, or accreditation(s) granted by any organisation.

G. Monogram of any kind or use of any kind of catch words is not permissible.

H. The Membership No./FRN (as may be applicable) is mandatory to be mentioned in the write-up.

I. It should not be of font size exceeding 14.

J. It must not be violative of any provisions of the Chartered Accountants Act, 1949, the Chartered Accountants Regulations, 1988, Code of Ethics, 2020 or any Guideline of the Council

The Institute of Chartered Accountants of India may issue a reasoned directive for removal or withdrawal of the whole write-up or of any part(s) thereof.

2. Advertisement through write-up

While advertising the services or details of Firms, the write-up may include only the following information:

(A) For Members

(i) CA……..Name

(ii) Membership No. with Institute

(iii) Age

(iv) Date of becoming ACA

(v) Date of becoming FCA

(vi) Date from which COP held

(vii) Recognized qualifications

(viii) Languages known

(ix) Telephone/Mobile/Fax No.

(x) Professional Address

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(xi) Website

(xii) E-mail

(xiii) CA Logo

(xiv) Passport *style*[3] photograph

(xv) Details of Employees (Nos. -)

(a) Chartered Accountants -

(b) Other Professionals –

(c) Articles/Audit Assistants

(d) Other Employees

(xvi) Names of the employees and their particulars on the lines allowed for a member as stated above.

(xvii) Services provided

(a) .....

(b) .....

(c) .....

(xviii) Position held as Director or Managing Director in a Management Consultancy Company registered with the Institute[4].

(B) For Firms

(i) Name of the Firm ..... Chartered Accountants

(ii) Firm Registration No. with Institute

(iii) Year of establishment.

(iv) Professional Address(s) registered with the Institute (both Head Office and Branches)

(v) Working Hours

(vi) Tel. No(s)/Mobile No./Fax No(s)

3 As ameanded by Council at its 388th Meeting held on 6th and 7th Feb., 2020.

4 As incorporated pursuant to decision of Council at its 388th Meeting held on 6th and 7th Feb., 2020.

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(vii) E-mail

(viii) No. of partners

(ix) Name of the proprietor/partners and their particulars on the lines allowed for a member as stated above including passport *style*[5] photograph.

(x) CA Logo

(xi) Details of Employees (Nos. -)

(a) Chartered Accountants -

(b) Other professionals –

(c) Articles/Audit Assistants

(d) Other employees

(xii) Names of the employees of the firm and their particulars on the lines allowed for a member as stated above.

(xiii) Services provided:

(a) .....

(b) .....

(c) .....

(xiv) Affiliation with a Network registered with the Institute[6]

The write-up may have the Signature, Name of the Member/ Name of the Partner signing on behalf of the firm, Place and Date.

3. Website of the CA Firms[7]

The Council has approved the detailed guidelines for posting the particulars on Website by Chartered Accountant(s) in practice and firm(s) of Chartered Accountants in practice :-

1. The Chartered Accountants and/or Chartered Accountants' Firms would be free to create their own Website. The following stipulations will be applicable on such websites:-

[5] As amended by Council at its 388th Meeting held on 6th and 7th Feb., 2020.

[6] As incorporated pursuant to decision of Council at its 388th Meeting held on 6th and 7th Feb. 2020.

[7] As amended and included under Guidelines for Advertisement pursuant to decision of Council at its 388th Meeting held on 6th and 7th Feb., 2020.

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2. The actual format of the Website is not being prescribed nor any standard format of the Website is being given to provide independence to the Members.

3. The Chartered Accountants and/or Chartered Accountants' Firms would ensure that their Websites are run on a "pull" model and not a "push" model of the technology to ensure that any person who wishes to locate the Chartered Accountants or Chartered Accountants' firms would only have access to the information and the information should be provided only on the basis of specific "pull" request.

4. The Chartered Accountants and/or Chartered Accountants' Firms should ensure that none of the information contained in the Website be circulated on their own or through E-mail or by any other mode or technique except on a specific "pull" request.

5. The Chartered Accountants would also not issue any circular or any other advertisement or any other material of any kind whatsoever by virtue of which they solicit people to visit their Website. The Chartered Accountants would, however, be permitted to mention their Website address on their professional stationery and email.

6. The following information may be allowed to be displayed on the Firms/Members' Websites:

   (i) Member/Trade/Firm name.

   (ii) Year of establishment.

   (iii) Member/Firm's Address (both Head Office and Branches)

   Tel. No(s)

   Fax No(s)

   E-mail ID(s)

   (iv) Nature of services rendered (to be displayable only on specific "pull" request)

   (v) Partners

Partners Name	Year of Qualification	Other Qualification(s)	Tel.. Off.- Direct Res. Mobile E-mail address	Area of Experience (to be displayable only on specific "pull" request)

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(vi) Details of Employees -

Professional	Others	Name	Designation	Area of experience (to be displayable only on specific "pull" request)

(vii) Job vacancies for the Chartered Accountant/firm of Chartered Accountants (including articleship).

(viii) No. of articled assistants. (to be displayable only on specific "pull" request).

(ix) Nature of assignments handled (to be displayable only on specific "pull" request). Names of clients and fee charged cannot be given. While the mention of names of clients is not permissible, members may take note of the following with regard to website of the Firm:-

Note: Disclosure of names of clients and/or fees charged, on the website is permissible only where it is required by a regulator, whether or not constituted under a statute, in India or outside India, provided that such disclosure is only to the extent of requirement of the regulator and is made only till such period that the member works under the purview of such Regulator/ such requirements of the Regulator are in force. Where such disclosure of names of clients and/or fees charged is made on the website, the member/ firm shall ensure that it is mentioned on the website [in italics], below such disclosure itself, that "This disclosure is in terms of the requirement of [name of the regulator] having jurisdiction in [name of the country/ area where such regulator has jurisdiction] vide [Rule/ Directive etc. under which the disclosure is required by the Regulator].

7. Display of Passport style photograph is permitted.

8. The members may include articles, professional information, bulletin boards, professional updation and other matters of larger importance or of professional interest on the website. Educational videos on topics of professional relevance are permissible.

9. The chat rooms can be provided which permit chatting amongst members of the ICAI and between Firms and its clients. The confidentiality protocol would have to be observed. The Firms can provide document management facility with distinct log in and password facility to the clients to access copies of their documents on the Firm website.

10. The Firm can provide link of its page on Social Networking site. However, the members should not solicit people to visit or like their respective page(s) on such social Networking site.

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11. The members/firms can provide on line advice to their clients who specifically request for the advice whether free of charge or on payment.

12. The details in the Website should be so designed that it does not amount to soliciting client or professional work. In case any content or technical feature of Website is against the professional Code of Conduct and Ethics as well as the restrictions contained in the schedules to the Chartered Accountants Act, 1949 or against the guidelines or directions issued by ICAI from time to time, appropriate action will be initiated by the ICAI in terms of its disciplinary mechanism either suo moto or on complaint as provided under the Chartered Accountants Act, 1949.

13. The Website should ensure adequate secrecy of the matters of the clients handled through Website.

14. No Advertisement in the nature of banner or any other nature will be permitted on the Website.

15. The Website should be befitting the profession of Chartered Accountants and should not contain any information or material which is unbecoming of a Chartered Accountant.

16. The Website may provide a link to the Website of ICAI, its Regional Councils and Branches and also the Website of Govt./Govt. Departments/Regulatory authorities/other Professional Bodies.

17. The Website address should be as near as possible to the individual name/trade name, firm name of the Chartered Accountant in practice or firm of Chartered Accountants in practice. But it should not amount to soliciting clients or professional work or advertisement of professional attainments or services. The Ethical Standards Board (ESB) of ICAI will decide in case there is any difficulty.

18. The Website should mention the information which is not at material variance from the information as per the ICAI's records.

4. Online Third Party Platforms

A number of non-Chartered Accountants' firms, corporates including banks, finance Companies and newspapers have set up their own Websites providing advisory services on taxation and other areas where Chartered Accountants are rendering professional service. Some of such Websites may request Chartered Accountants or Chartered Accountants' firms to provide consultation and advice through their Websites. No other service, besides consultancy and advice can be rendered through such websites, This would be permitted subject to the condition that on the Website, contact address of the Chartered Accountant concerned is not provided nor such Website will contain any material

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which advertises professional achievements or status of such Chartered Accountant except making a statement that they are Chartered Accountants. The name of Chartered Accountants' firm with suffix "Chartered Accountants" would not be permitted.

5. Publication of Name or Firm Name by Chartered Accountants in the Telephone or other Directories published by Telephone Authorities or Private Bodies

The Chartered Accountants and Chartered Accountants Firms may have entries made in a Telephone Directory (in printed and electronic form) either by making a special request or by means of an additional payment. The Council has also considered the question of permitting entries in respect of Chartered Accountants and their firms under specified groups in telephone/trade directories subject to the following additional restrictions :-

(i) The entry should not appear in any other section/category except that of 'Chartered Accountants'.

(ii) The member/firm should belong to the town/city in respect of which the directory is being published.

(iii) The order of the entries should not be in any manner other than alphabetical.

(iv) The entry should not be made in a differential or prominent manner giving the impression of publicity/advertisement.

(v) The entries should not be restricted and should be open to all the Chartered Accountants/firms of Chartered Accountants in the particular city/town in respect whereof the directory is published.

(vi) The members can also include their names in trade/ social directories.

6. Application based Service provider Aggregators

It is not permissible for members to list themselves with online Application based service provider Aggregators, wherein other categories like businessmen, technicians, maintenance workers, event organizers etc. are also listed.

7. Specialised Directories for limited circulation

The name, description and address of member (or firm) may appear in any directory or list of members of a particular body in which the names are listed alphabetically. For a specialised directory or a publication such as a "Who's Who" (including those compiled on purely local basis), a member should use his discretion in supplying information, bearing in mind the nature and purpose of the

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publications. In addition to his name, description and address and those of his firm, a member may give where appropriate, directorships held and reasonable personal details and may state his outside interests. He should not, however, give the names of any of his clients.

8. Exemptions

1 A special exemption has been made as regards publication of the name and address of a member or that of his firm, with the description Chartered Accountant(s), in an advertisement appearing in the press in the following circumstances, provided that the advertisement is not displayed more prominently than is usual for such advertisements or the name of the member or that of his firm with the designation Chartered Accountant(s) appears in type not bolder than the substance of the advertisement:-

(a) Advertisement for recruiting staff in the member's own office.

(b) Advertisement inserted on behalf of clients requiring staff or wishing to acquire or dispose of business or property.

(c) Advertisement for the sale of a business or property by a member acting in a professional capacity as trustee, liquidator or receiver.

2 When advertising for staff, it is desirable that members should avoid the expression such as "a well-known firm", since this would savour of advertisement. Similar considerations apply to advertisements for articled assistants. The advertisements should not contain any promotional element nor should there be any suggestion that the services offered by the Chartered Accountant or his firm are superior to those offered by other accountants.

10 RECOMMENDED SELF-REGULATORY MEASURES

As the members are aware, the Council has decided upon certain self-regulatory measures in order to ensure a healthy growth of the profession and an equitable flow of professional work among the members. These measures are reviewed from time to time and are published in the Journal of the Institute for observance by the members. The self-regulatory measures are recommendatory. However, considering the spirit underlying these measures, the Council expects that each and every member will effectively implement them. The Council earnestly believes that implementation of these measures would go a long way in ensuring equitable flow of work among the members and would also further enhance the prestige of the profession in the society.

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The more important of these recommendations are as under:

10.1 Branch Audits

The branch audits of a company should not be conducted by its statutory auditors consisting of ten or more members, but should be conducted by the local firms of auditors consisting of less than ten members. This should not be understood to mean any restriction on the right of the statutory auditors to have access over branch accounts conferred under the Companies Act, 2013. This restriction may not apply in the following cases.

(i) where the accounting records of the branches are maintained at the head office of the respective companies, and

(ii) where significant operations of an undertaking or a company are carried out at its branch office.

10.2 Joint Audit

In the case of large companies, the practice of associating a practicing firm with less than five members as Joint auditors should be encouraged. Where a client desires to appoint such a firm as joint auditor, the senior firm should not object to the same.

10.3 Ratio Between Qualified and Unqualified Staff

In the Council's view, a practicing firm of Chartered Accountants engaged in audit work should have at least one member for every five non-qualified members of the staff, excluding articled and audit assistants, typists, peons and other persons not engaged directly in such professional work.

10.4 Disclosure of Interest by Auditors in other Firms

The Council has decided that as a good and healthy practice, auditors should make a disclosure of the payments received by them for other services through the medium of a different firm or firms in which the said auditor may be either a partner or proprietor.

10.5 *Recommended Minimum Scale of Fees

The Institute has issued revised Minimum scale of Fees for the professional assignments of the members of ICAI. The recommended scale of Fees is to be charged as per the work performed for various professional assignments. The Fees has been recommended separately for Class-A, B and C cities.

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10.5.1 Fees - Relative Size:

Differentiated disclosure requirements for non public interest entities and public interest entities are following:-

1. **For non Public Interest Entities (PIE)-**Disclosure is required where for two consecutive years, the gross annual professional fees from an audit client represent more than 40% of the total fees of the firm.

2. **For public interest entities-** Disclosure is required where for two consecutive years, the gross annual professional fees from an audit client represent more than 20% of the total fees of the firm.

Exemption from applicability of the above provision will be in case where total Fees received by Firm does not exceed 20 lacs of rupees.

In addition, exemption from applicability of the above provision is also given in the case of audit of government Companies, public undertakings, nationalised banks, public financial institutions, regulators or where appointments of auditors are made by the Government.

Case Scenario

Synopsis: The case scenario underscores ethical and quality requirements to be complied with by statutory auditor of a listed company. Failure to perform audit of financial statements in accordance with Standards on Auditing can result in breakdown of trust of investors and public at large. The case involves issue of non-adherence to requirements of *SA 501, SA 550 and SA 505* by statutory auditor of a listed company.

Only major lapses have been considered for developing this case scenario for the sake of brevity.

The case scenario is presented in the following manner: -

I. Relevant provisions of the Companies Act, 2013 and requirements of relevant Standards on Auditing

II. Relevant Clauses of Part I of Second Schedule to Chartered Accountants Act, 1949

III. Facts of the case

IV. Major lapses pointed out by NFRA, engagement partner's submissions and NFRA's contentions/findings

V. Conclusion including its basis

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I. Relevant provisions of the Companies Act, 2013 and requirements of relevant Standards on Auditing

[1] Section 132(4) of the Companies Act, 2013

NFRA has power to investigate into matters of professional or other misconduct committed by any member or firm of chartered accountants registered under Chartered Accountants Act, 1949 for certain classes of bodies corporate. By virtue of this section, it has also got power to impose penalty on erring members and debarring members of firm from undertaking audit work.

[2] Relevant requirements of Standards on Auditing

- SA 501 requires that when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attendance at physical inventory counting *unless impracticable*.

  It further requires that if attendance at physical inventory counting is *impracticable,* the auditor shall perform *alternative audit procedures* to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall *modify the opinion* in the auditor's report in accordance with SA 705.

- SA 550 requires auditor to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately *identified, accounted for and disclosed in the financial statements* in accordance with the applicable financial reporting framework.

- SA 505 requires that in case management refuses to allow the auditor to send a confirmation request, reasons adduced by management need to be inquired and audit evidence has to be sought for as to validity and reasonableness of reasons. Further, implications of such refusal on risks of material misstatement *including risk of fraud* and on nature, timing and extent of other audit procedures are to be evaluated.

  It further requires auditor to perform *alternative audit procedures* designed to obtain relevant and reliable audit evidence.

II. Relevant clauses of Part I of Second Schedule to Chartered Accountants Act, 1949

- Under clause 7 of Part I of Second Schedule to Chartered Accountants Act, 1949, a chartered accountant in practice shall be deemed to be guilty of professional misconduct,

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if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

- Under clause 8 of Part I of Second Schedule to Chartered Accountants Act, 1949, a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion
- Under clause 9 of Part I of Second Schedule to Chartered Accountants Act, 1949, a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

III. Facts of the case

NFRA initiated action u/s 132(4) of the Companies Act, 2013 for investigating into professional misconduct of engagement partner of an audit firm pursuant to information received from ROC, Mumbai regarding investigation conducted by Regional Director into affairs of WNLL, listed on SME segment of BSE. The key financial data for company for financial year 2016-17 was as under: -

Particulars	Amount (in ₹ crores)
Revenue from Operations	51.77
PBT	1.44
Inventory	20.60
Trade receivables	14.93
Trade payables	13.78

The engagement partner had issued an unmodified opinion for financial year 2016-17. The engagement partner was requested on 18.02.2022 to submit audit file and SQC1 policy of firm which was submitted by him vide email dated 18.03.2022. Subsequently, a show-cause notice was issued to engagement partner charging him with professional misconduct for failure to perform his duties as engagement partner.

IV. Major lapses pointed out by NFRA, engagement partner's submissions and NFRA's contentions/findings

[1] Failure to obtain audit evidence regarding existence and condition of inventory

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The EP was charged with failure to obtain sufficient appropriate audit evidence regarding existence and condition of inventory by not attending physical inventory counting in accordance with SA 501.

	EP's submissions	*NFRA's contentions/findings*
1.	The appointment as statutory auditor was made on 18.4.2017. Therefore, it was not possible to attend physical verification of inventories as on 31.3.2017.	SA 501 requires if attendance at physical inventory count is ***impracticable***, ***alternative audit procedures*** shall be performed to obtain sufficient appropriate audit evidence regarding existence and condition of inventories. If it is not possible to so, the auditor shall ***modify*** opinion in accordance with SA 705. There was no documentation in audit file of audit procedures having been performed in this respect. Reliance was also placed on decision of PCAOB, US regulator in a similar case.
2.	Inventory holding level was in accordance with past trends. Stock records were cross verified in respect of selected items and reconciled with entries of receipts and issue in books of accounts.	There was no documentation in audit file of audit procedures having been performed in this respect.

[2] Failure to identify related party and related party transactions

The EP was charged with failure to identify related parties and transactions with them. The company made almost 100% of sales to a related party which was not identified as such in annual report of the company for FY 2016-17.

	EP's submissions	*NFRA's contentions/findings*
1.	It was tried to be ascertained from management regarding existence of related parties and previous audit reports were also relied upon in this regard.	The related party to whom 100% of sales was made was previously identified as related party in financial statements for FY 2013-14. Since almost 100% of sales were to this party, EP should have applied ***professional skepticism*** to probe further into antecedents of the party. There is no evidence in audit file regarding this. Reliance was also placed on similar decision of PCAOB where it was held that auditor must evaluate whether related party transactions have been properly accounted for and disclosed in financial statements.

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[3] Failure to obtain external confirmations for Trade receivables and Trade payables

The EP was charged with gross negligence for not obtaining direct confirmations of balances from debtors and creditors and with failure to perform any alternative audit procedure in absence of confirmations from debtors and creditors in accordance with SA 505.

	EP's submissions	*NFRA's contentions/findings*
1.	The company management had denied contact details of parties due to fear of losing the business information. Further, all debtors and creditors were outstanding for less than 6 months.	It shows that management had imposed a ***limitation on scope*** of audit. Limitations imposed by management may have other implications for audit such as ***evaluation of fraud risks and continuance of engagement as per SA 705.*** No assessment of fraud risk having been evaluated is available in audit file and there is no evidence of additional procedures being performed by EP in absence of external confirmations. Reliance was also placed on PCAOB order in ***Satyam case*** in which failure during audit to obtain external confirmation of bank balances was highlighted.

V. Conclusion including its basis

The engagement partner did not comply with provisions of the Chartered Accountants Act, 1949 and showed gross negligence and lack of due diligence in performing statutory audit. He didn't ensure audit quality and was grossly negligent of professional duties by not adhering to requirements laid down in relevant Standards on Auditing as discussed above. It led to issuance of audit report that was not backed by valid audit evidence and was lacking in audit quality.

The engagement partner was held guilty of professional misconduct under clauses 7, 8 and 9 of Part I of Second Schedule to Chartered Accountants Act, 1949. He was also penalized and debarred for a period of two years from undertaking any audit of financial statements or internal audit of the functions and activities of any company or body corporate.

Key Takeaways

- A Chartered Accountant, *either in practice or in service*, has to abide by these ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their jobs.

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- Service users of professionals should be able to feel secure that there exists a framework of professional ethics which governs the provision of those services. Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants.
- A distinguishing feature of the accountancy profession is its acceptance of the responsibility to act in the public interest. Code of Ethics seeks to protect the interests of the profession as a whole. It is a shield that enables us to command respect.
- Part 1 of Code of ethics deals with requirements relating to complying with the Code, Fundamental Principles and Conceptual Framework, and is applicable to all professional accountants.
- The Code delineates integrity, objectivity, professional competence and due care, confidentiality and professional behaviour as fundamental principles governing professional ethics.
- Part 2 of Code of ethics sets out requirements and application material for professional accountants in service when applying the conceptual framework. It does not describe all of the facts and circumstances, including professional activities, interests and relationships that could be encountered by professional accountants in service, which create or might create threats to compliance with the fundamental principles. Therefore, the conceptual framework requires professional accountants in service to be alert for such facts and circumstances.
- Part 3 of Code of ethics sets out requirements and application material for professional accountants in public practice when applying the conceptual framework.
- Part 4A and 4B of Code of ethics deal with independence standards for audit and review engagements (Part 4A) and assurance engagements other than audit and review engagements (Part 4B) respectively.
- There are specific provisions in Chartered Accountants Act, 1949 dealing with professional misconduct and other misconduct.
- Acts or omissions which comprise professional misconduct within the meaning of the Chartered Accountants Act are defined in two Schedules viz. the First Schedule and the Second Schedule.
- The First Schedule is divided into four parts, Part I of the First Schedule deals with the misconduct of a member in practice which would have the effect generally of compromising his position as an independent person. Part II deals with misconduct of members in services.

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Part III deals with the misconduct of members generally and Part IV deals with other misconduct in relation to members of the institute generally.

- The Second Schedule is divided into three parts. Part I deals with misconduct in relation to a member in practice, Part II deals with misconduct of members generally and Part III deals with other misconduct in relation to members of the Institute generally.

ANNEXURE – 1

The Chartered Accountants Act, 1949

The Chartered Accountants Act, 1949 (No. 38 of 1949) came into force on the 1st day of July, 1949. Later in the year 1959, certain amendments were made therein through the Chartered Accountants (Amendment) Act, 1959 (No.15 of 1959). After about 47 years extensive changes have been made in the Act through the Chartered Accountants (Amendment) Act, 2006 (No.9 of 2006) which have been notified by the Central Government in the Gazette of India (Extra Ordinary) dated 23rd March, 2006. Further, few insertions were made to the principle Act through the Chartered Accountants (Amendment) Act, 2011 (No. 3 of 2012).

The entire Act is divided in nine chapters [Including chapter VIIA inserted by Chartered Accountants (Amendment) Act, 2006].

The Complete enumeration of Contents is given below:

Chapter I - Preliminary

1. Short title, Extent and Commencement
2. Interpretation

This Chapter contains preliminary aspects of the Act like applicability of the Act, definition of various terms like, Chartered Accountant, Council, holder of a restricted certificate, Registered Accountant, etc.

Chapter II - The Institute of Chartered Accountants of India

3. Incorporation of the Institute
4. Entry of names in the Register
5. Fellows and Associates
6. Certificate of Practice

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7. Members to be known as Chartered Accountants

8. Disabilities

This chapter deals with various things like who shall be entitled to have his name entered in the register of members of the Institute, who shall be deemed to have become an associate member of the Institute, who shall be entered in the Register as a fellow of the Institute. This Chapter also deals with issues relating to certificate of practice and disabilities of a person for having his name entered in the Register.

Chapter III - Council of the Institute

9. Constitution of the Council of the Institute

10. Re-election or re-nomination to Council [Substituted by Chartered Accountants (Amendment) Act, 2006]

10A. Settlement of dispute regarding election [Inserted by Chartered Accountants (Amendment) Act, 2006]

10B. Establishment of Tribunal [Inserted by Chartered Accountants (Amendment) Act, 2006]

11. Nomination in default of election or nomination

12. President and Vice-President

13. Resignation of Membership and casual vacancies

14. Duration and dissolution of the Council

15. Function of the Council

15A. Imparting education by Universities and Other bodies [Inserted by Chartered Accountants (Amendment) Act, 2006]

16. Officers and employees, salary, allowances etc. [substituted by Chartered Accountants (Amendment) Act, 2006]

17. Committees of the Council

18. Finances of the Council

This Chapter deals with various issues like composition of Council of the Institute, manner of conducting election to the Council, mode of tendering resignation from the membership of the Council mode of filling a casual vacancy, various duties of the Council. This Chapter also deals with

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the permission accorded to any University established by law or any Body affiliated to the Institute to impact education on the subjects covered by the academic courses of the Institute.

Chapter IV - Register of Members

19. Register of Members

20. Removal from the Register

This chapter deals with the matters relating to register of members and removal from the register the name of any member. The Council has to maintain a Register of Members of the Institute. This Register shall include name, date of birth, domicile, residential and professional address, qualification etc. Also, the Council may remove from the Register the name of any member in certain circumstances like in case of death of the member or if the member does not pay the prescribed fees, or when a member has become subject to any of the disabilities mentioned in section 8.

Chapter V - Misconduct

21. Disciplinary Directorate [Substituted by Chartered Accountants (Amendment) Act, 2006]

21A. Board of Discipline [Inserted by Chartered Accountants (Amendment) Act, 2006]

21B. Disciplinary Committee [Inserted by Chartered Accountants (Amendment) Act, 2006]

21C. Authority, Disciplinary Committee, Board of Discipline and Director (Discipline) to have powers of civil court [Inserted by Chartered Accountants (Amendment) Act, 2006]

21D. Transitional provisions [Inserted by Chartered Accountants (Amendment) Act, 2006]

22. Professional or other misconduct defined [Substituted by Chartered Accountants (Amendment) Act, 2006]

22A. Constitution of Appellate Authority [Substituted by Chartered Accountants (Amendment) Act, 2006]

22B. Term of office of Chairperson and members of Authority [Inserted by Chartered Accountants (Amendment) Act, 2006].

22C. Allowances and conditions of service of Chairperson and Members of Authority (Inserted by Chartered Accountants (Amendment) Act, 2006)

22D. Procedure to be regulated by Authority [Inserted by Chartered Accountants (Amendment) Act, 2006]

22E. Officers and other staff of Authority [Inserted by Chartered Accountants (Amendment) Act, 2006]

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22F. Resignation and removal of Chairperson and Members [Inserted by Chartered Accountants (Amendment) Act, 2006)]

22G. Appeal to Authority [Inserted by Chartered Accountants (Amendment) Act, 2006]

In this chapter professional and other misconduct has been defined. As per section 22 of the Act, the expression "professional or other misconduct " shall be deemed to include any act or omission provided in any of the Schedules. In this chapter, Section 21, 22 and 22A have been substituted by new sections 21, 22 and 22A. Other sections (Section 21A, 21B, 21C, 21D, 22B, 22C, 22D, 22E, 22F and 22G) have been inserted by Chartered Accountants (Amendment) Act, 2006. These Sections along with the Schedules deal with the new Disciplinary Mechanism.

Chapter VI - Regional Councils

23. Constitution and Functions of Regional Councils

The Councils may constitute such Regional Councils for the purpose of advising and assisting it on matters concerning its functions. The Regional councils shall exercise prescribed functions.

Chapter VII - Penalties

24. Penalty for falsely claiming to be a member etc.

24A. Penalty for using name of the Council, awarding degree of Chartered Accountancy etc.

25. Companies not to engage in accountancy

26. Unqualified persons not to sign documents

27. Maintenance of branch offices

28. Sanction to prosecute

This chapter lists penalties in various cases like, if a person who is not a member of the Institute and represents himself as a member of the Institute or uses the designation Chartered Accountant, he shall be punishable with fine which may extend to one thousand rupees (on first conviction) and with imprisonment which may extend to six months or with fine which may extend to five thousand rupees or with both (on subsequent conviction). Other provisions regarding penalties that are included in this chapter provide that a Company (Incorporated in or outside India) shall not practice as Chartered Accountant, a person other than a member of the Institute shall not sign any document an behalf of a Chartered Accountant in practice or a firm of such Chartered Accountants in his or its professional capacity, etc.

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Chapter VII A Quality Review Board

[Inserted by Chartered Accountants (Amendment) Act, 2006]

28A. Establishment of Quality Review Board

28B. Functions of Board

28C. Procedure of Board

28D. Terms and conditions of services of Chairperson and Members of Board and its expenditure

After Chapter VII, the Chapter VIIA has been inserted by the Chartered Accountants (Amendment) Act, 2006. It empowers the Central Government to constitute a Quality Review Board outside the framework of the Institute. It will perform the functions like, to make recommendations to the Council with regard to the quality of services provided by the members of the Institute, to review the quality of services provided by the members of the Institute including audit services and to guide the members of the Institute to improve the quality of services and adherence to the various statutory and other regulatory requirements.

Chapter VIII – Miscellaneous

29. Reciprocity

29A. Power of Central Government to make rules.

30. Power to make regulations

30A. Powers of the Central Government to direct regulation to be made or to make or amend regulations

30B. Rules, Regulations and notification to be laid before Parliament [Substituted by Chartered Accountants (Amendment) Act, 2006]

30C. Power of Central Government to issue directions [Inserted by Chartered Accountants (Amendment) Act, 2006)]

30D. Protection of action taken in good faith [Inserted by Chartered Accountants (Amendment) Act, 2006)]

30E. Members etc. to be public servants [Inserted by Chartered Accountants (Amendment) Act, 2006)]

31. Construction of References

32. Act not to affect right of accountants to practice as such in Acceding States.

33. [Repealed]

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This Chapter contains miscellaneous provisions. It empowers the Council to prescribe the conditions subject to which foreign qualifications relating to accountancy shall be recognized for the purpose of entry in the Register. It also empowers the Council to make regulations for the purpose of carrying out the objects of this Act. It also empowers the Central Government to direct the Council to make any regulations or to amend or revoke any regulations already made. Section 30C, 30D, and 30E have been inserted by Chartered Accountants (Amendment) Act, 2006. Section 30C empowers the Central Government to issue directions in the event of non-compliance by the Council of any provisions of the Act. Section 30D protects Central Government, Council, Authority Disciplinary Committee, Tribunal, Board, Board of Discipline, Disciplinary Directorate or any officer thereof, for anything which is in good faith done or intended to be done under this Act or any rule, regulation, notification, direction or order made there under. Section 30E says that the Chairperson, Presiding officer, Members and other officers and employees of the Authority, Disciplinary Committee, Tribunal, Board, Board of Discipline or the Disciplinary Directorate shall be deemed to be public servants within the meaning of Section 21 of the Indian Penal Code.

ANNEXURE – 2

SCHEDULES TO THE ACT

Acts or omissions which comprise professional misconduct within the meaning of Section 22 of the Chartered Accountants Act are defined in two Schedules viz. the First Schedule and the Second Schedule.

The First Schedule is divided into four parts, Part I of the First Schedule deals with the misconduct of a member in practice which would have the effect generally of compromising his position as an independent person. Part II deals with misconduct of members in services. Part-III deals with the misconduct of members generally and part IV deals with other misconduct in relation to members of the institute generally. The Second Schedule is divided into three parts. Part I deals with misconduct in relation to a member in practice, Part II deals with misconduct of members generally and part III deals with other misconduct in relation to members of the Institute generally. The implication of the different clauses in the schedules are discussed below:

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The First Schedule

PART I - Professional misconduct in relation to Chartered Accountants in practice

A Chartered Accountant in practice is deemed to be guilty of professional misconduct if he:

Clause (1) allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him.

Clause (2) pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

Clause (3) accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute.

Clause (4) enters into partnership, in or outside India, with any person other then Chartered Accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under close (V) of sub-section (1) of section 4 or whose qualifications are recognized by the Central Government or the Council for the purpose of permitting such partnerships.

Clause (5) secures either through the services of a person who is not an employee of such Chartered Accountant or who is not his partner or by means which are not open to a Chartered Accountant, any professional business.

Provided that nothing herein contained shall be construed as prohibiting any agreement permitted in terms of item (2), (3) and (4) of this part.

Clause (6) solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Provided that nothing herein contained shall be construed as preventing or prohibiting -

(i) Any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice; or

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(ii) A member from responding to tenders or enquiries issued by various users of professional services or organizations from time to time and securing professional work as a consequence.

However, as per the guideline issued by the Council of the Institute of Chartered Accountants of India, a member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for chartered accountants, such as audit and attestation services. However, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.

Clause (7) advertises his professional attainments or services, or uses any designation or expressions other than the Chartered Accountant on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a University established by law in India or recognized by the Central Government or a title indicating membership of the Institute of Chartered Accountants or of any other institution that has been recognized by the Central Government or may be recognized by the Council.

Provided that a member in practice may advertise through a write up, setting out the service provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council.

Clause (8) accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been Issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing.

Clause (9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 (1 of 1956), or sections 139 to 141 of the Companies Act, 2013 or any other law pertaining to appointment of auditors for the time being in force, in respect of such appointment have been duly complied with.**

(Now Section 139 and 140 read with Section 141 of the Companies Act, 2013. Students may note that till the time Code of Ethics etc. bare documents get updated from Ethical Standard Board of ICAI in pursuance of the Companies Act, 2013, students are required to understand the basic nature of the provision and quote the same along with the new corresponding provisions.)

Clause (10) charges or offers to charge, accepts or offers to accept In respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the

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findings, or results of such employment, except as permitted under any regulations made under this Act.

The Council of the Institute has however framed Regulation 192 which exempts members from the operation of this clause in certain professional services.

Clause (11) engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company (Not being managing director or a whole time director) unless he or any of his partners is interested in such company as an auditor.

Clause (12) allows a person not being a member of the institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

PART II - Professional misconduct in relation to members of the Institute in service

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person:

Clause (1) pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him.

Clause (2) accepts or agrees to accept any part of fees, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

[Note: A member in the foregoing circumstances would be guilty of misconduct regardless of the fact that he was in whole-time or part-time employment or that he was holding Certificate of Practice along with his employment.]

PART III - Professional misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he:

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he:

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Clause (1) not being a fellow of the Institute, acts as a fellow of the Institute.

Clause (2) does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority.

Clause (3) while inviting professional work from another chartered accountant or while responding to tenders or enquiries or while advertising through a write up, or anything as provided for in items (6) and (7) of Part I of this Schedule, gives information knowing it to be false.

PART IV - Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he:

(1) is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months.

(2) in the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

These clause (1) & (2) are self explanatory and any of the member of the Institute is found guilty by any civil or criminal court and prosecuted for an imprisonment in an offence involving moral turpitude or his acts bring disrepute to the profession or the Institute, irrespective of the fact whether such acts are related to profession or not, such member will be deemed to be guilty of other misconduct in Part IV of Schedule I.

The important point to note is that if imprisonment tenure exceeds six months, this case will be covered in the clause of Part III of Schedule II.

The Second Schedule

PART I - Professional misconduct in relation to chartered Accountant in practice

A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he:

Clause (1) discloses Information acquired in the course of his professional engagement to any person other than his client so engaging him without the consent of his client or otherwise than as required by any law for the time being in force.

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Clause (2) if he certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee In his firm or by another chartered accountant in practice.

Clause (3) permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast.

Clause (4) expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.

Clause (5) fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement not misleading where he is concerned with that financial statement in a professional capacity.

Clause (6) fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

Clause (7) does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

Clause (8) fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.

Clause (9) fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

Clause (10) fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

PART II - Professional misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he:

Clause (1) contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

Clause (2) being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being

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in force or except as permitted by the employer.

Clause (3) includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline. Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

Clause (4) defalcates or embezzles money received in his professional capacity.

Clause (5) acts as an auditor of the company in contravention of the provisions of the Companies Act, 2013.

Part III - Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

Imprisonment awarded for a term exceeding six months in any civil/criminal matter treated as a major offence under 'other misconduct' is included in this Schedule.

Where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the second schedule or in both the Schedule, he shall place the matter before the Disciplinary Committee.

Recent Decisions of Ethical Standards Board

1. ***It is not permissible for member in practice being a statutory auditor to prepare Business Responsibility & Sustainability Reporting (BRSR) study to Audit Clients. However, he may provide advisory services on the same. It is permissible for member in practice being a statutory auditor to be "Assurance provider of BRSR core" (Ref. SEBI circular dt. 12.07.2023) for the same client.***
2. ***Statutory auditor of an entity is not permitted to engage in assignment of compilation engagement, of that entity as per SRS 4410.***
3. ***It is permissible for members in practice to engage in the services assessment/performance audit of the centres of skill development council of Government of India as these are permissible under Management Consultancy and other services issued under section 2(2)(iv) of Chartered Accountants Act, 1949.***
4. ***It is permissible for a member in practice to accept the assignment of Mystery Audit.***
5. ***It is permitted for a member in practice to mention position as promoter/Director on the portal of a Company. However, the member cannot mention his professional attainments and the name of the firm with which he is associated. There should be no***

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violation of clause (6) and Clause (7) of Part-I of First Schedule to the Chartered Accountants Act, 1949 in doing so.

6. ***It is permissible for a member in practice to become professional director in the Board of Management of a Co-operative Bank.***

7. ***It is permissible for a member to set up practice in IFSC/GIFT city.***

8. ***It is permissible for a member to render professional services to IFSC units from offices outside IFSC.***

9. ***A firm is not permitted to publish its vision or mission statement on letter head, visiting card or stationery etc. The vision and mission statement may be printed on the firm profile and may be provided in response to a specific request.***

10. ***It is not permissible for a member/ firm being the statutory Auditor of a Bank to accept the assignment of ASM of a customer of the same Bank simultaneously. He can accept either of the Assignments at one time.***

11. ***A member in practice cannot be appointed as an Internal Auditor and Procurement officer simultaneously in an organization.***

12. ***It is permissible for members in practice to charge fees on a percentage of utilization amount of an educational Institute for certifying the amount (utilization) spent by an educational Institute out of grant.***

13. It is not permissible for a member in practice to accept the appointment of statutory audit of the society wherein immediate family member i.e., spouse or dependent, of member hold honorary position of one of the managing committee of the institutes governed by the society.

14. There is no conflict of interest in a Chartered Accountant, who is a member of a Trust, being the auditor of the said trust. It is subject to the exception where a particular statute governing a Trust prescribes prohibition on the member of the Trust to be its Auditor or otherwise where there is conflict of interest as per the provisions of Code of Ethics.

15. It is not permissible for a member to use Messaging Applications to send messages to make people aware about his practice, and mention the services provided therein.

16. It is permissible for a practicing Chartered Accountant holding Certificate of Practice to become a member of the 'Board of Management' in Primary (Urban) Co-operative Banks. The Ethical Standards Board noted that the position of a member of 'Board of Management' in Primary (Urban) Co-operative banks (UCBs) and the role attached to that position is similar

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to that of a Director-Simiplicitor; where there is no involvement of a member in the day-to-day functioning/operations and not signatory etc. and only sitting fees for the services rendered are provided.

17. Member in practice cannot act as Trademark or Patent Attorney. However, Professional advice in relation to Intellectual Property Rights (IPR) is a routine professional work for a Chartered Accountants in practice and same is permissible under the provisions of the Chartered Accountants Act, 1949.

18. There is no prohibition for internal auditor of a company to acquire/purchase shares of the said Company.

19. A CA Firm may register itself on Udyog Aadhar, a web portal of Ministry Micro, Small and Medium Enterprises.

20. A chartered accountant in practice can provide services through kiosk only if the services provided are professional activities of a practicing chartered accountant, permitted under the Act.

21. It is permissible for two or more Chartered Accountants in practice collectively to have joint training session for their clients on GST, and share the fees collected from the clients thereof.

22. A Member in practice may be a Non-executive/independent director in a Co-operative Bank, provided he is not involved into day to day activity of the organization, nor he or any of his partners are interested in the Bank as an auditor.

23. A Chartered Accountant in practice being Director Simplicitor in a Company cannot sign ROC Forms of the Company as it is a direct conflict of role.

24. A Chartered Accountant in practice can act as Authorized Representative of a Foreign Company, provided he is not the auditor of the said Company.

25. A Chartered Accountant in service is allowed to take e-return registration if it does not conflict with employment obligation. However, he cannot certify the return.

26. In case where Chartered Accountant in practice is a non-executive director in a company, he or a Firm in which he is a partner, should not accept the appointment as a statutory auditor of a Company which is a joint venture of the original Company, as it would impact independence.

27. A Chartered Accountant in practice may be an equity research adviser, but he cannot publish retail report, as it would amount to other business or occupation.

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28. A Chartered Accountant in practice may engage himself as Registration Authority (RA) for obtaining digital signatures for clients.

29. A Chartered accountant can hold the credit card of a bank when he is also the auditor of the bank, provided the outstanding balance on the said card does not exceed Rs 100,000* beyond the prescribed credit period limit on credit card given to him. (*As per the limit of indebtedness existing as on date.)

30. A Chartered Accountant in practice can act as mediator in Court, since acting as a "mediator" would be deemed to be covered within the meaning of "arbitrator'; which is inter-alia permitted to members in practice as per Regulation 191 of the Chartered Accountants Regulations, 1988.

31. A Chartered Accountant in practice is not permitted to accept audit assignment of a bank in case he has taken loan against a Fixed Deposit held by him in that bank.

32. The Ethical Standards Board in 2013 generally apply the stipulations contained in the then amended Rule 11U of Income Tax generally, wherein statutory auditor /tax auditor cannot be the valuer of unquoted equity shares of the same entity. The Board has at its recent Meeting (January, 2017) has reviewed the above, and decided that where law prohibits for instance in the Income Tax Act and the rules framed thereunder, such prohibition on statutory auditor/tax auditor to be the valuer will continue, but where there is no specific restriction under any law, the said eventuality will be permissible, subject to compliance with the provisions, as contained in the Code of Ethics relating to independence.

33. The Ethical Standards Board had in 2011 decided that it is not permissible for a member who has been Director of a Company, upon resignation from the Company to be appointed as an auditor of the said Company, and the cooling period for the same may be 2 years. The Board has at its recent Meeting (January, 2017) has reviewed the above, and noted that the Section 141 of the Companies Act, 2013 on disqualification of auditors does not mention such prohibition; though threats pertaining to the said eventuality have been mentioned in Code of Ethics. Further, the Board was of the view that a member may take decision in such situation based on the provisions of the Companies Act, 2013 and provisions of Code of Ethics.

34. A chartered accountant in practice cannot become Financial Advisors and receive fees/commission from Financial Institutions such as Mutual Funds, Insurance Companies, NBFCs etc.

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35. A chartered accountant cannot exercise lien over the client documents/records for non-payment of his fees.

36. It is not permissible for CA Firm to print its vision and values behind the visiting cards, as it would result in solicitation and therefore would be violative of the provisions of Clause (6) of Part-I of First Schedule to the Chartered Accountants Act, 1949.

37. It is not permissible for chartered accountants in practice to take agencies of UTI, GIC or NSDL.

38. It is permissible for a member in practice to be a settlor of a trust.

39. A member in practice cannot hold Customs Brokers Licence under section 146 of the Customs Act, 1962 read with Customs Brokers Licensing Regulations, 2013 in terms of the provisions of Code of Ethics.

40. A Chartered accountant in service may appear as tax representative before tax authorities on behalf of his employer, but not on behalf of other employees of the employer.

41. A chartered accountant who is the statutory auditor of a bank cannot for the same financial year accept stock audit/inspection Audit of the same branch of the bank or any of the branches of the same bank or sister concern of the bank, for the same financial year.

42. A CA Firm which has been appointed as the internal auditor of a PF Trust by a Government Company cannot be appointed as its Statutory Auditor.

43. A concurrent auditor of a bank 'X' cannot be appointed as statutory auditor of bank 'Y', which is sponsored by 'X'.

44. A CA/CA Firm can act as the internal auditor of a company & statutory auditor of its employees PF Fund under the new Companies Act (2013).

45. The Ethical Standards Board while noting that there is requirement for a Director u/s 149(3) of the Companies Act, 2013 to reside in India for a minimum period of 182 days in the previous calendar year, decided that such a Director would be within the scope of Director Simplicitor (which is generally permitted as per ICAI norms) , if he is non –executive director, required in the Board Meetings only , and not paid any remuneration except for attending such Board Meetings.

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TEST YOUR KNOWLEDGE

Theoretical Questions

1. *P, a Chartered Accountant in practice provides management consultancy and other services to his clients. During 2024, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients. Is P guilty of professional misconduct?*

2. *Mr. G, a Chartered Accountant in practice as a sole proprietor has an office in Mumbai near Church Gate. Due to increase in professional work, he opens another office in a suburb of Mumbai which is approximately 80 kilometers away from the municipal limits of the city. For running the new office, he employs three retired Income-tax Officers. Is Mr. G guilty of professional misconduct?*

3. *Write a short note on Other Misconduct.*

4. *Mr. K, a practicing Chartered Accountant gave 50% of the audit fees received by him to a non-Chartered Accountant, Mr. L, under the nomenclature of office allowance and such an arrangement continued for a number of years. Discuss this in the light of Professional Ethics issued by ICAI.*

5. *Mr. X who passed his CA examination of ICAI on 18th July, 2024 and started his practice from August 15, 2024. On 16th August 2024, one female candidate approached him for articleship. In addition to monthly stipend, Mr. X also offered her 1 % profits of his CA firm. She agreed to take both 1 % profits of the CA firm and stipend as per the rate prescribed by the ICAI. The Institute of Chartered Accountants of India sent a letter to Mr. X objecting the payment of 1 % profits. Mr. X replies to the ICAI stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the financial position of the articled clerk is very weak. Is Mr. X liable to professional misconduct?*

6. *M/s XYZ, a firm in practice, develops a website "xyz.com". The colour chosen for the website was a very bright green and the web-site was to run on a "push" technology where the names of the partners of the firm and the major clients were to be displayed on the web-site without any disclosure obligation from any regulator. Is this website in compliance with guidelines issued by ICAI in this regard?*

7. *A partner of a firm of chartered accountants during a T.V. interview handed over a bio-data of his firm to the chairperson. Such bio-data detailed the standing of the international firm*

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with which the firm was associated. It also detailed the achievements of the concerned partner and his recognition as an expert in the field of taxation in the country. The chairperson read out the said bio-data during the interview. Discuss whether this action by the Chartered Accountant would amount to misconduct or not.

8. (a) *An advertisement was published in a Newspaper containing the photograph of Mr. X, a member of the institute wherein he was congratulated on the occasion of the opening ceremony of his office.*

   (b) *Mr. X, a Chartered Accountant and the proprietor of X & Co., wrote several letters to the Assistant Registrar of Co-operative Societies stating that though his firm was on the panel of auditors, no audit work was allotted to the firm and further requested him to look into the matter.*

9. *A practising Chartered Accountant uses a visiting card in which he designates himself, besides as Chartered Accountant, Cost Accountant. Is this a misconduct?*

10. *Mr. Nigal, a Chartered Accountant in practice, delivered a speech in the national conference organized by the Ministry of Textiles. While delivering the speech, he told to the audience that he is a management expert and his firm provides services of taxation and audit at reasonable rates. He also requested the audience to approach his firm of chartered accountants for these services and at the request of audience he also distributed his business cards and telephone number of his firm to those in the audience. Comment.*

11. *Mr. A is a practicing Chartered Accountant working as proprietor of M/s A & Co. He went abroad for 3 months. He delegated the authority to Mr. Y a Chartered Accountant his employee for taking care of routine matters of his office. During his absence Mr. Y has conducted the under mentioned jobs in the name of M/s A & Co.*

    (i) He issued the audit queries to client which were raised during the course of audit.

    (ii) He issued production certificate to a client under the GST Act.

    (iii) He attended the Income Tax proceedings for a client as authorized representative before Income Tax Authorities.

    Please comment on eligibility of Mr. Y for conducting such jobs in name of M/s A & Co. and liability of Mr. A under the Chartered Accountants Act, 1949.

12. *XYZ Co. Ltd. has applied to a bank for loan facilities. The bank on studying the financial statements of the company notices that you are the auditor and requests you to call at the bank for a discussion. In the course of discussions, the bank asks for your opinion regarding*

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the company and also asks for detailed information regarding a few items in the financial statements. The information is available in your working paper file. What should be your response and why?

13. *Mr. A, a newly qualified Chartered Accountant, started his practice and sought clients through telephone calls from his family and friends, almost all of them employed in one or the other retail trade business. One of his friends Mr. X gave him an idea to start online services and give stock certifications to traders with Cash Credit Limits in Banks. Mr. A started a website with colorful catchy designs and shared the website address on his all social media posts and stories and tagged 30 traders of his local community with the caption "Easy Online Stock Certification Services". Discuss if the actions of Mr. A are valid in the light of the Professional Ethics and various pronouncements and guidelines issued by ICAI.*

14. *Mr. D, a practicing CA, is appointed as a Director Simplicitor in XYZ Pvt. Ltd. After one year of appointment, Mr. D resigned as the Director and accepted the Statutory Auditor position of the company. Is Mr. D right in accepting the auditor position?*

15. *Mr. F, a Chartered Accountant, gave advisory services to PQR Pvt. Ltd. Further, he gave them GST consultancy, compilation engagement for historical financial information and helped in ERP set up. Later, the company turned out to be a part of a group of companies involved in money laundering. Mr. F was asked to provide details of the companies. Mr. F refused on the grounds that he gave only consultancy services to the company and wasn't supposed to keep any information about the company. Is Mr. F right as per the guidelines issued by the ICAI?*

16. *Mr. S, the auditor of ABC Pvt. Ltd. has delegated following works to his articles and staff:*

    i. *Issue of audit queries during the course of audit.*

    ii. *Issue of memorandum of cash verification and other physical verification.*

    iii. *Letter forwarding draft observations/financial statements.*

    iv. *Issuing acknowledgements for records produced.*

    v. *Signing financial statements of the company.*

    Is this correct as per the Professional Ethics and ICAI's guidelines and pronouncements?

17. *Mr. S is a practising chartered accountant based out of Chennai. During the weekends, he involved himself in equity research and used to advise his friends, relatives and other known people who are not his clients. Apart from this, he was also involved as a paper-setter for*

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Accountancy subject in the school in which he studied. He also owned agricultural land and was doing agriculture during his free time. During the year 20X1, heavy losses were incurred in agricultural activity due to natural calamities and misfortune, and he lost almost all of his wealth and became undischarged insolvent. After a few court hearings, finally, in the year 20X3, he was declared discharged insolvent and obtained a certificate from the court stating that his insolvency was caused by misfortune without any misconduct on his part. You are required to comment on the above situation with reference to the Chartered Accountants Act, 1949 and Schedules thereto, (especially from the point of section 8: Entry of name in Register of Members).

18. ***CA Pankaj accepted professional work of acting as valuer under direct taxes. He charges fees on a percentage of the property valued. Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto.***

19. ***Mr. Johny, a chartered accountant, was invited to a seminar on bank audits to give a presentation on the process of conducting such audits. During his presentation, he provided examples from his clients' experiences and shared the significant information about clients with the intention of aid in understanding of audience on the topic. Does above situation have implications in relation to the professional ethics?***

20. ***CA Vaayu is the auditor of Viva Limited having a turnover of more than ₹ 200 Crores. The audit fee for the year is fixed at ₹ 80 Lakhs. During the year, the company offers CA Vaayu an assignment of representation before Income Tax Appellate Tribunal for certain matter for remuneration of ₹ 1.75 crores. CA Vaayu accepted the assignment. Discuss action of CA Vaayu with reference to the provisions of the Chartered Accountants (Amendment) Act, 2006 and Schedules thereto.***

21. ***Sanjeev & Associates, a firm of Chartered Accountants responded to a tender from a PF Office, Chembur for filing quarterly e-TDS returns. The terms of tender are as follows:***

    (i) Earnest Money Deposit of ₹ 7,500/-

    (ii) It is open for all categories

    (iii) Maximum fees of ₹ 7,500/- per quarter

    Discuss whether Sanjeev and Associates can respond to the said tender with reference to provisions of the Chartered Accountants (Amendment) Act, 2006 and Schedules thereto.

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22. *CA Shubh, a Chartered Accountant in practice specializing in the field of Information Systems Audit. He is considered to be one of the experts in this field because of his command over the subject. ZX Limited, a company engaged in rendering management consultancy offered him to appoint as its managing director. CA Shubh accepted the position of managing director without obtaining prior permission from the Institute. One of his friends, CA Varun informed him that now he cannot retain full time certificate of practice, thus cannot do attestation function and train articled assistants. Comment with reference to the provisions of the Chartered Accountants Act, 1949 and Schedules thereto.*

23. *Pitch Private Limited requested CA Angad, a practicing Chartered Accountant, to digitally sign the form related to resignation of Mr. Ravi, one of the Director of Pitch Private Limited, along with the copy of resignation letter to be uploaded on the website of Registrar of Companies. The signature of Mr. Ravi was simply copied and pasted by another Director of Pitch Private Limited. CA Angad, without verifying the genuineness of the resignation letter, digitally signed the form and the said form was uploaded on the website of Registrar of Companies. Comment with reference to the provisions of the Chartered Accountants Act, 1949 and Schedules thereto.*

24. *Shri Limited, a listed Company, having its registered office at Mumbai is engaged in manufacturing of various types of yarns to be supplied to the textile mills. The Company has installed pollution control equipment for processing the pollutants so that before discharge of effluents outside the factory, the level of pollution is kept at a level below the prescribed standard. The company managed to get the pollution clearance certificate by unfair means, while still there continues to be breach of pollution control laws in matters of discharge of polluting effluents. The amount of ₹ 18.75 Lacs had been incurred for arranging clearance certificate and the amount incurred unlawfully had been booked as pollution recycling expenditure. The matter had not reached those in governance, and the Director-Finance, who is a Chartered Accountant, came to know of these matters on review of major expenditure incurred during the period. Comment on the action/responses expected of Director - Finance (CA Gopal) referring to any applicable requirements of Responses for NOCLAR under Code of Ethics.*

25. *CA Kapila, in practice, is desirous of filling Multi-purpose Empanelment Form (MEF) for inclusion of her name in panel for allotment of statutory audit of bank branches web hosted by Professional Development Committee (PDC) of ICAI for financial year*

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2023-24. The form requires applicants to upload XML files of their personal income tax returns along with computation of income. During relevant year for which information is being sought by PDC, CA Kapila has transacted in futures and options derivatives (equity) and has reflected income from such transactions in her return of income as "Business Income". Analyse the above situation with reference to the provisions of the Chartered Accountants Act, 1949.

Would it make any difference if CA Kapila had earned income from transacting in currency derivatives and commodity derivatives?

26. *In terms of subsection 114 of Revised Code of Ethics, a professional accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as result of professional and employment relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant in knowledge that the information will not be disclosed to a third party. In this context, enumerate the circumstances where professional accountants are or might be required to disclose confidential information or when such disclosure might be appropriate. In deciding whether to disclose confidential information what are the points that should be kept in the mind of professional accountants?*

27. *CA Raj, a practicing chartered accountant, is offered to take up an appointment as a "Secretary" in his professional capacity by the Central Government for a Metro Project for a term of 2 years not on a salary-cum-full-time basis. After giving deep thought to the offer, CA Raj accepted the appointment. Comment in terms of the Chartered Accountant Act, 1949 and Schedules thereto.*

28. *TP Limited is a listed company engaged in the business of manufacturing of kids garments under the brand name of MM. M/s R & Associates, firm of chartered accountants, are appointed as a Statutory Auditor of the Company for the year 2023-24. CA R is looking after the audit of the Company. During the audit, CA R observed that there are number of notices received from GST Department and Income-tax Department for various issues. Further during plant visit, CA R observed that few child labourers are engaged in some of the activity. In response to the observation made, CA R followed the procedure as envisaged in SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". According to CA R, the provisions of SA 250 and the provisions of NOCLAR (Non-Compliance with Laws and Regulations)*

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under Revised Code of Ethics are one and the same. Do you agree? If not, give your comments.

29. *CA Kumar, a practicing-chartered accountant, is well known in the field of pleading of Income-tax cases at Income-tax Tribunal and does not provide any assurance services. Considering the long standing in the field, CA Kumar is approached by XYZ Limited to file an appeal in the Tribunal against the Income-tax Demand of ₹ 10 crore which was added by the CIT(A) and to plead on behalf of XYZ Limited in the matter. CA Kumar offers to accept the case with the following fee structure:*

The fees for filing an appeal and to plead at the Income-tax Tribunal will be 10% of Tax Demand Reduced.

Comment on the act of CA Kumar in terms of the Chartered Accountant Act, 1949 and Schedules thereon.

30. *GeM (e-market place) is a public procurement portal which provides opportunities to start-ups, entrepreneurs etc. to showcase their innovative products and services to government buyers and engage in public procurement. The Government e Marketplace Special Purpose Vehicle (GeM SPV), a 100% government owned and section 8 (Non-Profit) company under the Ministry of Commerce, Government of India has been incorporated under the Companies Act, 2013 to develop, manage and maintain GeM platform. Whether a firm of Chartered Accountants can register on GeM portal for rendering professional services to government departments?*

31. *CA Gyan is a Chartered Accountant in practice and also an engineer by qualification. He wants to pursue a registered valuer course and work as a registered valuer for plant and machinery under the Companies Act, 2013. Comment on above with reference to provisions of the Chartered Accountants Act, 1949.*

32. *CA Evan has been in practice for two years and runs his proprietorship firm in the name of "Evan & Co.". He maintains notes in his mobile where he records the fees received from various clients. Using these records, he prepares and files his income tax return. Comment with respect to the provisions of the Chartered Accountant Act, 1949.*

33. *The manager of Miskin (P) Ltd. approached CA Rahul in need of a certificate in respect of a consumption statement of raw material. Without having a certificate of practice (CoP), CA Rahul issued the certificate to the manager of the company, acting as a CA*

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in practice and applied for the CoP to the Institute on very next day to avoid any dispute.

34. ***A special notice has been issued for a resolution at 4th annual general meeting of TRIM Ltd., providing expressly that CA Lucky shall not be re-appointed as an auditor of the company. Consequently, CA Lucky submitted a representation in writing to the company with a request to circulate to the members. In the detailed representation, CA Lucky included the contributions made by him in strengthening the control procedures of the company during his association with the company and also indicated his willingness to continue as an auditor if reappointed by the shareholders of the company. Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto.***

35. ***CA Anita joined as an audit executive in a CA firm on April 1, 2024. Despite receiving multiple*** **reminders from ICAI, she has failed to respond with her appointment date and submit her membership certificate. Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto.**

Hints/Answers to Theoretical Questions

1. **Advising on Portfolio Management Services:** The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "Management Consultancy and other Services" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

   In view of this, P would be guilty of misconduct under the Chartered Accountants Act, 1949.

2. In terms of section 27 of the Chartered Accountants Act, 1949, if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. There is however an exemption for the above if the second office is located in the same premises, in which the first office is located; or the second office is located in the same city, in which the first office is located; or the second office is located within a distance of 50 kms from the municipal limits of a city, in which the first office

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is located. Since the second office is situated beyond 50 kms of municipal limits of Mumbai city, he would be liable for committing a professional misconduct.

3. Refer Para 7.2

4. **Sharing of Audit Fees with Non-Member:** As per Clause (2) of Part I of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant in practice pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

In the instant case, Mr. K, a practising Chartered Accountant gave 50% of the audit fees received by him to a non-Chartered Accountant, Mr. L, under the nomenclature of office allowance and such an arrangement continued for a number of years. In this case, it is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

The Chartered Accountant had shared his profits and, therefore, Mr. K will be held guilty of professional misconduct under the Clause (2) of Part I of First Schedule to the Chartered Accountants Act, 1949.

5. **Sharing Fees with an Articled Clerk:** As per Clause (2) of Part I of First Schedule to the Chartered Accountants Act 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

In view of the above, the objections of the Institute of Chartered Accountants of India, as given in the case, are correct and reply of Mr. X, stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the position of the articled clerk is weak is not tenable.

Hence, Mr. X is guilty of professional misconduct in terms of Clause (2) of Part I of First Schedule to the Chartered Accountants Act 1949.

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6. **Posting of Particulars on Website:** The Council of the Institute had approved posting of particulars on website by Chartered Accountants in practice under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949 subject to the prescribed guidelines. The relevant guidelines in the context of the website hosted by M/s XYZ are:

- No restriction on the colours used in the website;
- The websites are run on a "pull" technology and not a "push" technology;
- Names of clients and fees charged not to be given.

However, disclosure of names of clients and/or fees charged, on the website is permissible only where it is required by a regulator, whether or not constituted under a statute, in India or outside India, provided that such disclosure is only to the extent of requirement of the regulator. Where such disclosure of names of clients and/or fees charged is made on the website, the member/ firm shall ensure that it is mentioned on the website [in italics], below such disclosure itself, that "This disclosure is in terms of the requirement of [name of the regulator] having jurisdiction in [name of the country/area where such regulator has jurisdiction] vide [Rule/ Directive etc. under which the disclosure is required by the Regulator].

In view of the above, M/s XYZ would have no restriction on the colours used in the website but failed to satisfy the other two guidelines. Thus, the firm would be liable for professional misconduct since it would amount to soliciting work by advertisement.

7. Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits solicitation of client or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means since it shall constitute professional misconduct. The bio-data was handed over to the chairperson during the T.V. interview by the Chartered Accountant which included details about the firm and the achievements of the partner as an expert in the field of taxation. The chairperson simply read out the same in detail about association with the international firm as also the achievements of the partner and his recognition as an expert in the field of taxation. Such an act would definitely lead to the promotion of the firms' name and publicity thereof as well as of the partner and as such the handing over of bio-data cannot be approved. The partner would be held guilty of professional miscount under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

8. (a) **Publishing an Advertisement Containing Photograph:** As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or

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professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. X published an advertisement in a Newspaper containing his photograph on the occasion of the opening ceremony of his office. On this context, it may be noted that the advertisement which had been put in by the member is quite prominent. If soliciting of work is allowed, the independence and forthrightness of a Chartered Accountant in the discharge of duties cannot be maintained.

The above therefore amounts to soliciting professional work by advertisement directly or indirectly. Mr. X would be therefore held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(b) **Soliciting Professional Work:** As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. X, a Chartered Accountant and proprietor of M/s X and Co., wrote several letters to the Assistant Registrar of Co-operative Societies, requesting for allotment of audit work. In similar cases, it was held that the Chartered Accountant would be guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949. The writing of continuous letter to ascertain the reasons for not getting the work is quite alright but in case such either amount to request for allowing the work then Mr. X will be liable for professional misconduct.

Consequently, Mr. X would therefore be held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

9. **Cost Accountant:** As stated in the Illustration given in clause 7 with reference to tax consultant, this would also constitute misconduct under section 7 of the Act read with Clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949. A chartered accountant in practice cannot use any other designation than that of a chartered accountant. Nevertheless, a member in practice may use any other letters or descriptions indicating membership of accountancy bodies which have been approved by the Council. Thus, it is improper for a chartered accountant to state in his documents that he is a "Cost Accountant". However as per the Chartered Accountants Act, 1949, the Council has resolved that the

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members are permitted to use letters indicating membership of the Institute of Cost and Works Accountants but not the designation "Cost Accountant".

10. **Using Designation Other Than a CA and Providing Details of Services Offered:** Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

Section 7 of the Chartered Accountants Act, 1949 read with Clause (7) of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public. Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council.

Member may appear on television and films and agree to broadcast in the Radio or give lectures at forums and may give their names and describe themselves as Chartered Accountants. Special qualifications or specialized knowledge directly relevant to the subject matter of the programme may also be given but no reference should be made, in the case of practicing member to the name and address or services of his firm. What he may say or write must not be promotional of his or his firm but must be an objective professional view of the topic under consideration.

Thus, it is improper to use designation "Management Expert" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council. Therefore, he is deemed to be guilty of professional misconduct under both Clause (6) and Clause (7) as he has used the designation “Management Expert” in his speech and also he has made reference to the services provided by his firm of Chartered Accountants at reasonable rates. Distribution of cards to audience is also a misconduct in terms of Clause (6).

11. **Delegation of Authority to the Employee:** As per Clause (12) of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be

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guilty of professional misconduct "if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements".

In this case CA A proprietor of M/s A & Co., went to abroad and delegated the authority to another Chartered Accountant Mr. Y, his employee, for taking care of routine matters of his office who is not a partner but a member of the Institute of Chartered Accountants

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated and such delegation will not attract provisions of this clause like issue of audit queries during the course of audit, asking for information or issue of questionnaire, attending to routing matters in tax practice, subject to provisions of Section 288 of Income Tax Act etc.

(i) In the given case, Mr. Y, a chartered accountant being an employee of M/s A & Co. has issued audit queries which were raised during the course of audit. Here Y is right in issuing the query, since the same falls under routine work which can be delegated by the auditor. Therefore, there is no misconduct in this case as per Clause (12) of Part I of First schedule to the Act.

(ii) Further, issuance of production certificate to a client under GST Act by Mr. Y being an employee of M/s A & Co. (an audit firm), is not a routine work and it is outside his authorities. Thus, CA A is guilty of professional misconduct under Clause (12) of Part I of First Schedule of the Chartered Accountants Act, 1949.

(iii) In this instance, Mr. Y, CA employee of the audit firm M/s A & Co. has attended the Income tax proceedings for a client as authorized representative before Income Tax Authorities. Since the council has allowed the delegation of such work, the chartered accountant employee can attend to routine matter in tax practice as decided by the council, subject to provisions of Section 288 of the Income Tax Act. Therefore, there is no misconduct in this case as per Clause (12) of Part I of First schedule to the Act.

12. As per Clause (1) of Part I of the Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of the client or otherwise than as required by law for the time being in force. SA 200 on " Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" also reiterates that, "the auditor should respect the confidentiality of information acquired in the course of his work

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and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose".

In the instant case, the bank has asked the auditor for detailed information regarding a few items in the financial statements available in his working papers. Having regard to the position stated earlier, the auditor cannot disclose the information in his possession without specific permission of the client. As far as working papers are concerned, working papers are the property of the auditor. The auditor may at his discretion, make portions of or extracts from his working papers available to his client".

Thus, there is no requirement compelling the auditor to divulge information obtained in the course of audit and included in the working papers to any outside agency except as and when required by any law.

13. As per Clause (6) of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Mr. A is wrong in seeking clients through family and friends. Creating a website is not a non-compliance provided it is in line with the guidelines issued by the Institute in this regard. One of the guidelines is that the website should not be in push mode. Further, mentioning of clients' names is also prohibited as per the guidelines.

In the given situation, Mr. A shared the website address on his all social media posts and stories and tagged 30 traders of his local community with the caption "Easy Online Stock Certification Services" mentioning his current clients as well. This is in complete contravention of the guidelines on the website issued by the ICAI.

Thus, CA A would be held guilty of professional misconduct under clause 6 of Part 1 of First Schedule of the Chartered Accountants Act, 1949.

14. As per Clause (4) of Part I of the Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.

Section 141 of the Companies Act, 2013 specifically prohibits a member from auditing the accounts of a company in which he is an officer or employee. Although the provisions of the aforesaid section are not specifically applicable in the context of audits performed under other statutes, e.g. tax audit, yet the underlying principle of independence of mind is equally

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applicable in those situations also. Therefore, the Council's views are clarified in the following situations.

As per the clarifications issued by the Council, a member shall not accept the assignment of audit of a Company for a period of two years from the date of completion of his tenure as Director, or resignation as Director of the said Company.

In the instant case, Mr. D, a practicing CA, is appointed as a Director Simplicitor in XYZ Pvt. Ltd. After one year of appointment, Mr. D resigned as the Director and accepted the Statutory Auditor position of the company. In view of the above provisions Mr. D cannot accept the Directorship of the company until the completion of two years after his resignation.

Thus, CA D would be held guilty of professional misconduct under clause 4 of Part 1 of Second Schedule of the Chartered Accountants Act, 1949.

15. The financial services industry globally is required to obtain information of their clients and comply with Know Your Client Norms (KYC norms). Keeping in mind the highest standards of Chartered Accountancy profession in India, the Council of ICAI issued such norms to be observed by the members of the profession who are in practice.

In the given situation, CA F, gave GST consultancy, compilation engagement for historical financial information and helped in ERP set up along with advisory services to PQR Pvt. Ltd. Mr. F was asked to provide details of the companies as the company, turned out to be a part of a group of companies, involved in money laundering. Contention of Mr. F that he gave only consultancy services and compilation engagement for historical financial information to the company and wasn't supposed to keep any information about the company is not valid as Mr. F should have kept following information in compliance with KYC Norms which are mandatory in nature and shall apply in all assignments pertaining to attestation functions.

In the given case of PQR Pvt. Ltd., a Corporate Entity, Mr. F should have kept following information:

A. General Information

- Name and Address of the Entity
- Business Description
- Name of the Parent Company in case of Subsidiary
- Copy of last Audited Financial Statement

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B. Engagement Information

- Type of Engagement

C. Regulatory Information

- Company PAN No.
- Company Identification No.
- Directors' Names & Addresses
- Directors' Identification No.

16. As per Clause (12) of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated in the following instances and such delegation will not attract provisions of this clause:

(i) Issue of audit queries during the course of audit.

(ii) Asking for information or issue of questionnaire.

(iii) Letter forwarding draft observations/financial statements.

(iv) Initiating and stamping of vouchers and of schedules prepared for the purpose of audit.

(v) Acknowledging and carrying on routine correspondence with clients.

(vi) Issue of memorandum of cash verification and other physical verification or recording the results thereof in the books of the clients.

(vii) Issuing acknowledgements for records produced. Raising of bills and issuing acknowledgements for money receipts.

(ix) Attending to routine matters in tax practice, subject to provisions of Section 288 of Income Tax Act.

(x) Any other matter incidental to the office administration and routine work involved in practice of accountancy.

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In the instant case, Mr. S, the auditor of ABC Pvt. Ltd. has delegated certain task to his articles and staff such as issue of audit queries during the course of audit, issue of memorandum of cash verification and other physical verification, letter forwarding draft observations/financial statements, issuing acknowledgements for records produced and signing financial statements of the company.

Therefore, Mr. S is correct in allowing first four tasks i.e. issue of audit queries during the course of audit, issue of memorandum of cash verification and other physical verification, letter forwarding draft observations/financial statements, issuing acknowledgements for records produced to his staff and articles.

However, if the person signing the financial statements on his behalf is not a member of the institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, Mr. S is wrong in delegating signing of financial statements to his staff.

Conclusion: In view of this, S would be guilty of professional misconduct for allowing the person signing the financial statements on his behalf to his articles and staff under Clause 12 of Part 1 of First Schedule of the Chartered Accountants Act, 1949.

17. Given situation can be visualised in following parts:

(A) **Mr. S used to involve himself in equity research and used to advise his friends, relatives and other known people:** As per the recent decisions taken by the Ethical Standards Board of ICAI, a Chartered Accountant in practice may be an equity research adviser, but he cannot publish a retail report, as it would amount to other business or occupation.

In the given case, though Mr. S is involved in doing equity research and in advising people, it is clear that he does not publish any retail report of his research. Hence, this act of Mr. S shall not make him guilty of professional misconduct.

(B) Mr. S is involved in paper-setting for the Accountancy subject in the school where he studied. He also owns agricultural land and does agriculture activities: As per Clause 11 of Part I of First Schedule of the Chartered Accountants Act and regulation 190A of Chartered Accountants Regulations, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

Further, Regulation 190A mentions the 'Permissions granted Generally' to engage in a certain category of occupations, for which no specific permission of Council is required. Those cases include:

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- Valuation of papers, acting as paper-setter, head examiner or a moderator, for any examination.
- Owning agricultural land and carrying out agricultural activities.

Therefore, in the given case, the activities of Mr. S as a paper-setter and involvement in agricultural activities do not make him guilty of professional misconduct.

(C) Mr. S was discharged insolvent: Disabilities for the Purpose of Membership : Section 8 of the Chartered Accountants Act, 1949 enumerates the circumstances under which a person is debarred from having his name entered in or borne on the Register of Members, If he, being a discharged insolvent, has not obtained from the court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part. Here it may be noted that a person who has been removed from membership for a specified period shall not be entitled to have his name entered in the Register until the expiry of such period.

In addition, failure on the part of a person to disclose the fact that he suffers from any one of the aforementioned disabilities would constitute professional misconduct. The name of the person, who is found to have been subject at any time to any of the disabilities discussed in section 8, can be removed from the Register of Members by the Council.

In the given case, it is clearly stated that Mr. S was discharged insolvent, and he has also obtained from the court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part. Hence, Mr. S has not violated the provisions of Section 8, and he is not debarred from having his name entered in the Register of Members.

18. Restriction on fees based on a Percentage: According to Clause (10) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

However, Regulation 192 exempts Chartered Accountants in practice to charge fees based on a percentage of profits or contingent upon findings or results for professional work for certain professional services.

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Regulation 192 specifically states that in the case of a valuer for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of the property valued.

Conclusion: Consequently, CA Pankaj shall not be deemed to be guilty of professional misconduct, as he is within the permissible scope of charging fees based on a percentage of the property valued.

19. *Disclosure of Client's Information: Confidentiality is one of fundamental principles governing professional ethics. Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949, addresses professional misconduct related to the disclosure of information by a chartered accountant in practice concerning the business of their clients. Such disclosure to any person other than the client, without the client's consent or unless mandated by prevailing law, is considered a breach of conduct. The Code of Ethics emphasizes that this duty continues even after the completion of the assignment, except when disclosure is necessary for the performance of professional duties.*

In the provided case, CA Johny disclosed significant information about his client's business without obtaining the client's consent, believing that it would enhance the audience's understanding of the topic.

Conclusion: Therefore, this action of CA Johny constitutes professional misconduct under Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

20. *As per the Council General Guidelines 2008, under Chapter IX on appointment as statutory auditor a member of the Institute in practice shall not accepts the appointment as a statutory auditor of a PSUs'/Govt company(ies)/Listed company(ies) and other public company(ies) having a turnover of ₹ 50 crores or more in a year and where he accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking. For this purpose, the other work/services include Management Consultancy and all other professional services permitted by Council excluding audit under any other statute, Certification work required to be done by the statutory auditor and any representation before an authority.*

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In the given case, the company offers CA Vaayu, the statutory auditor, an assignment of representation before Income Tax Appellate Tribunal for remuneration of ₹ 1.75 Crores.

Conclusion: In view of the above provision, it would not be misconduct on Vaayu's part if he accepts the assignment of representation before Income Tax Appellate Tribunal for remuneration of ₹ 1.75 crore.

21. *As per Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.*

Provided that nothing herein contained shall be construed as preventing or prohibiting -

(i) Any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice; or

(ii) A member from responding to tenders or enquiries issued by various users of professional services or organisations from time to time and securing professional work as a consequence.

However, as per the Guidelines issued by the Council of the Institute of Chartered Accountants of India, a member of the Institute in practice shall not respond to any tender issued by an organisation or user of professional services in areas of services which are exclusively reserved for chartered accountants, such as audit and attestation services. However, such a restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.

In the given case, Sanjeev & Associates responded to a tender from a PF Office, Chembur, filing quarterly e-TDS returns.

Conclusion: Sanjeev & Associates can respond to the said tender as the tender is open to all the categories i.e. it is open to other professionals along with the Chartered Accountants.

22. *As per Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of the Chartered Accountant unless permitted by the Council so to engage.*

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As per the Guidelines for Corporate Form of Practice, the Council has allowed the members in practice to hold the office of Managing Director, Whole-time Director or Manager of a body corporate within the meaning of the Companies Act, 2013 provided that the body corporate is engaged exclusively in rendering Management Consultancy and Other Services permitted by the Council in pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 and complies with the conditions(s) as specified by the Council from time to time in this regard. The name of the Management Consultancy Company is required to be approved by the Institute and such a Company has to be registered with the Institute.

The members can retain a full-time Certificate of Practice besides being the Managing Director, Whole-time Director or Manager of such management consultancy company. There will be no restriction on the quantum of the equity holding of the members, either individually and/ or along with the relatives, in such a company. Such members shall be regarded as being in full- time practice and therefore can continue to do attest function either in individual capacity or in Proprietorship/Partnership firm in which capacity they practice and wherein they are also entitled to train articled/audit assistants.

In the given case, CA Shubh, a Chartered Accountant specializing in Information Systems Audit and considered an expert in the field, was offered the position of Managing Director by ZX Limited, a management consultancy firm. He accepted the role without obtaining prior permission from the Institute of Chartered Accountants of India

From the above provisions, it can be concluded that the action of CA Shubh is valid.

23. *As per Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty if he does not exercise due diligence or is grossly negligent in the conduct of this professional duties.*

In the given case, Pitch Private Limited requested CA Angad, a practicing Chartered Accountant, to digitally sign the form related to resignation of Mr. Ravi, one of the Director of Pitch Private Limited, along with the copy of Resignation Letter to be uploaded on the website of Registrar of Companies. The signature of Mr. Ravi was simply copied and pasted by another Director of Pitch Private Limited.

CA Angad, without verifying the genuineness of the Resignation Letter, digitally signed the Form and the said form was uploaded on the website of Registrar of Companies.

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Due to forged resignation letter, the resignation of Mr. Ravi from directorship of the Pitch Private Limited had been occurred. It was noted that CA Angad had not taken any step to verify forged signature on resignation letter which anyone would have taken in normal circumstances.

Hence, CA Angad would be held liable for professional misconduct as per Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

24. *In the given situation, Shri Limited, a listed company, has installed pollution control equipment for processing the pollutants to keep the level of pollution below the prescribed standard. The company managed to get pollution certificate by unfair means whereas breach of pollution control laws still continues. For arranging clearance certificate amount of ₹ 18.75 lacs had been incurred unlawfully. CA Gopal, Director Finance, came to know about these matters on review of the same during the period.*

NOCLAR, under Code of Ethics, is applicable on professional accountants in service, and in practice. Among those in practice, it applies to Auditors, as well as professional services other than Audit.

It is applicable to Senior Professional Accountants in service, being employees of listed entities. Senior professional accountants in service ("senior professional accountants") includes directors.

NOCLAR takes into account non-compliance that causes substantial harm resulting in serious consequences in financial or non-financial terms.

As per NOCLAR, in exceptional circumstances, the professional accountant might become aware of an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having first considered whether it would be appropriate to discuss the matter with management or those charged with governance of the company, the accountant shall exercise professional judgment and determine whether to disclose the matter immediately to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach. If disclosure is made, that disclosure is permitted.

CA Gopal, Director-Finance is expected of taking the following action/responses:

- *Obtaining an understanding of the Matter.*
- *Addressing the matter.*

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- *Seeking advice.*
- *Determining whether further action is needed.*
- *Determining whether to disclose the matter to an Appropriate Authority.*
- *Imminent breach.*
- *Documentation.*

25. *Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he engages in any business or occupation other than the profession of Chartered Accountants unless permitted by the Council so to engage.*

Provided that nothing contained herein shall disentitle a Chartered accountant from being a director of a Company, (not being a managing director or a whole-time director), unless he or any of his partners is interested in such company as an auditor.

Ethical Standards Board of ICAI has announced that it is permissible for a member in practice to engage in derivative transactions in his personal capacity but not in professional capacity i.e. for clients. Such engagements in derivatives are not violative of provisions of Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949. Further, members are allowed to transact in equity and currency derivatives. There is no requirement to take permission of Council in this matter.

Therefore, there is no difference if CA Kapila had earned income from currency derivatives. However, in accordance with the announcement of Ethical Standards Board of ICAI, it is not permissible for members in practice to transact in commodity derivative transactions. In such a case, CA Kapila would be held guilty of professional misconduct for engaging in business other than profession of Chartered Accountancy.

26. *Principle of Confidentiality: In terms of subsection 114 of Revised Code of Ethics, a professional accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as a result of professional and employment relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant in the knowledge that the information will not be disclosed to a third party. Nevertheless, the following are circumstances where professional accountants are or might be required to disclose confidential information or when such disclosure might be appropriate:*

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(1) Disclosure is required by law,

(2) Disclosure is permitted by law and is authorized by the client or the employing organisation;

(3) There is a professional duty or right to disclose, when not prohibited by law:

(i) To comply with the requirements of Peer Review or Quality Review of the Institute;

(ii) To respond to an inquiry or investigation by a professional or regulatory body;

(iii) To protect the professional interests of a professional accountant in legal proceedings; or

(iv) To comply with technical and professional standards, including ethics requirements.

In deciding whether to disclose confidential information, professional accountants should consider the following points:

(1) Whether the interests of any party, including third parties whose interests might be affected, could be harmed if the client or employing organization consents to the disclosure of information by the professional accountant;

(2) Whether all the relevant information is known and substantiated, to the extent it is practicable; and

(3) The proposed type of communication, and to whom it is addressed;

(4) Whether the parties to whom the communication is addressed are appropriate recipients.

27. As per Section 2(2)(iv) of the Chartered Accountant Act, 1949 as amended from time to time, a member of the Institute shall be deemed 'to be in practice' when individually or in partnership with Chartered Accountants in practice, or in partnership with members of such other recognized professional as may be prescribed, he, in consideration of remuneration received or to be received, renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice.

As per Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

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However, the Council of the Institute is empowered to permit chartered accountants in practice to engage in any other business or occupation considered fit and proper. Accordingly, the Council formulated Regulations 191 to the Chartered Accountants Regulations, 1988 specifying the activities with which a member in practice can associate himself with or without the permission of the Council. As per Regulation 191 a Chartered Accountant in practice may take up an appointment that may be made by the Central Government or a State Government or a court of law or any other legal authority or may act as a secretary in his professional capacity, provided his employment is not on a salary-cum-full-time basis".

In the instant case, CA Raj, a practicing chartered accountant has been appointed as a "Secretary" in his professional capacity by the Central Government for a metro project for a term of 2 years not on a salary-cum-full-time basis.

Conclusion: In view of above, in the given scenario, CA Raj will not be held liable for misconduct for acceptance of appointment as Secretary in terms of compliance of Regulations 191 read with Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949.

28. *In the given situation, CA R is looking after the audit of TP Limited, a listed company. During the audit, CA R observed that there are a number of notices received from GST Department and Income-tax Department for various issues. Further during plant visit, CA R observed that few child labourers are engaged in some of the activity. In response to the observation made, CA R followed the procedure as envisaged in SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". assuming the provisions of SA 250 and the provisions of NOCLAR (Non-Compliance with Laws and Regulations) under Revised Code of Ethics are one and the same. However, following points indicates that the provisions of SA 250 and NOCLAR (Non-Compliance with Laws and Regulations) under the Revised Code of Ethics are not one and same:*

    (i) SA 250 is applicable only on Audit, and not on other Assurance engagements. However, NOCLAR is applicable on professional accountants in service, and in practice.

    (ii) SA 250 talks of auditor's responsibilities for laws having direct effect on the determination of material amounts and disclosures in the financial statements (such as tax and labour laws); and other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the

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financial statements, but compliance with which may be fundamental to the operating aspects of the business. NOCLAR, while being alike to SA 250 till this point, is further ahead of it in that it takes into account non-compliance that causes substantial harm resulting in serious consequences in financial or non-financial terms.

(iii) SA 250 does not define stakeholders. NOCLAR is related to affect of non-compliance on investors, creditors, employees as also the general public.

(iv) As per NOCLAR, in exceptional circumstances, the professional accountant might become aware of an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having first considered whether it would be appropriate to discuss the matter with management or those charged with governance of the company, the accountant shall exercise professional judgment and determine whether to disclose the matter immediately to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach. If disclosure is made, that disclosure is permitted. This provision is not existent in SA 250.

29. Restriction on Fees based on a Percentage: According to Clause (10) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

However, Regulation 192 allow the Chartered Accountant in practice to charge the fees in respect of any professional work which are based on a percentage of profits, or which are contingent upon the findings or results of such work, in the case of a non-assurance services to non-audit clients, and the fees may be based on a percentage of Tax Demand Reduced.

In the given case, CA Kumar, a practicing Chartered Accountant, provides non-assurance services. He is approached by XYZ Limited, a non-audit client, to file an appeal in Tribunal against Income-tax Demand of ₹10 crore which was added by the CIT(A) and to plead on behalf of XYZ Limited in the matter. CA Kumar offers to accept the case and agrees to charge fees 10% of Tax Demand reduced.

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Conclusion: Therefore, Mr. Kumar will not be held guilty of professional misconduct since he is not providing any assurance services to non-audit clients pursuant to Regulation 192 read with Clause 10 of Part I of First Schedule.

30. ***As per provisions of Council Guidelines for Advertisement, 2008, it is not permissible for members to list themselves with online application based service provider Aggregators, wherein other categories like businessmen, technicians, maintenance workers, event organizers etc. are also listed.***

Further, as per explanation to Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, the government departments, government Companies/ corporations, courts, cooperative societies and banks and other similar institutions prepare panels of Chartered Accountants for allotment of audit and other professional work. Where the existence of such a panel is within the knowledge of a member, he is free to write to the concerned organization with a request to place his name on the panel. However, it would not be proper for the Chartered Accountant to make roving enquiries by applying to any such organization for having his name included in any such panel. It is permissible to quote fees on enquiries being received or respond to tenders from the organizations requiring professional services, which maintain such panel.

Getting registered on GeM portal by members does not appear to amount either to empanelment or listing on Aggregator. In Aggregator, it is the third party which is operating, and not the client itself. GeM is operated by the client itself.

It is a pre-requirement of rendering professional services to the Government departments, as stipulated by them, and be considered as ancillary requirement to providing services to the Government departments. Firms of Chartered Accountants are permitted to register on GeM Portal for rendering professional services as there is no violation of the ethical norms of the Institute in registering on the GeM portal and such registration on the Portal is a pre-requirement for providing services to the Government departments/ organisations.

However, firms should ensure compliance with the tender guidelines issued by the Institute while participating in tender or bid floated through GeM Portal. The ICAI has made an announcement in relation to the above.

31. ***As per section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with the Chartered Accountants in practice or in partnership with members of such other***

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recognised professions as may be prescribed, he, in consideration of remuneration received or to be received, renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice.

Pursuant to section 2(2) (iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services" which, inter alia, includes rendering services of valuation of shares and business and advice regarding amalgamation, merger and acquisition, acting as Registered Valuer under the Companies Act, 2013 read with the Companies (Registered Valuers and Valuation) Rules, 2017. In this regard, such rules qualify Chartered Accountants for valuation of the securities or the financial Assets only and not for the Plant and Machinery. Therefore, valuation of plant and machinery does not form part of Management Consultancy and other services permitted by the council.

Further, in accordance with the resolution passed under Regulation 190A of the Chartered Accountant Regulations, 1988, members in practice are generally permitted for attending classes and appearing for any examination. There is no need to take prior permission of ICAI in this regard. Therefore, it is generally permitted for a member in practice to attend classes and appear for any examination, and accordingly, doing the Registered valuer course would be deemed as permissible.

Hence, keeping in view above and in terms of the provisions of the Chartered Accountants Act, 1949 and Code of Ethics, it is not permissible for a Chartered Accountant in practice to work as an Engineer/ valuer in plant & machinery simultaneously.

32. *Maintenance of Books of Account by a CA in Practice: Chapter V of the Council General Guidelines, 2008 specifies that a member of the Institute in practice or the firm of Chartered Accountants of which he is a partner, shall maintain and keep in respect of his professional practice, proper books of accounts including the following-*

(i) a Cash Book

(ii) a Ledger

Thus, a Chartered Accountant in practice is required to maintain proper books of accounts.

In the instant case, CA Evan does not maintain proper books of accounts and writes the fees received from various clients in notes on his mobile. Notes maintained by him in mobile cannot be treated as books of accounts.

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Hence, CA Evan, being a practicing Chartered Accountant will be held guilty of misconduct for violation of Council General Guidelines, 2008.

33. *Issuing Certificate without having Certificate of Practice: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the Regulations made thereunder or any Guidelines issued by the Council.*

This clause requires every member of the Institute to act within the framework of the Chartered Accountants Act,1949 and the Regulations made thereunder. Any violation either of the Act or the Regulations by a member would amount to misconduct.

In the given case, CA Rahul has issued a certificate in respect of a consumption statement of raw material to the manager of Miskin (P) Ltd., as a Chartered Accountant in practice when he had not even applied for the CoP to the Institute, thereby contravening the provisions of section 6 of the Chartered Accountants Act, 1949.

Therefore, CA Rahul will be held guilty of professional misconduct in terms of Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949 for contravention of provisions of this Act.

34. *Soliciting Clients: As per Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means except applying or requesting for or inviting or securing professional work from another Chartered Accountant in practice and responding to tenders.*

Further, section 140(4)(iii) of the Companies Act, 2013, provides a right to the retiring auditor, to make representation in writing to the company. The retiring auditor has the right for his representation to be circulated among the members of the company and to be read out at the meeting. However, the content of letter should be set out in a dignified manner how he has been acting independently and conscientiously through the term of his office and may, in addition, indicate, if he so chooses his willingness to continue as auditor, if re- appointed by the shareholders.

The proposition of the auditor to highlight contributions made by him in strengthening the control procedures in the representation should not be included in such

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representations because the representation letter should not be prepared in a manner to seek publicity.

Thus, highlighting contributions made by him in strengthening the control procedures, while submitting representation u/s 140(4)(iii) of the Companies Act, 2013 would amount to canvassing or soliciting for his continuance as auditor.

Therefore, CA Lucky will be held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

35. *Failed to Supply Information Called For: In accordance with Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949, a member, whether in practice or not, is considered to be engaged in professional misconduct if he fails to provide the information requested or does not comply with the requirements set forth by the Institute, Council, or any of its Committees, including the Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board, or the Appellate Authority.*

Conclusion: Therefore, in the given scenario, CA Anita has neglected to respond to the Institute's letters seeking confirmation of her appointment date and has not submitted her membership certificate. Consequently, she is deemed to be guilty of professional misconduct as given in Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949.

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CHAPTER 19

PROFESSIONAL ETHICS & LIABILITIES OF AUDITORS



LEARNING OUTCOMES

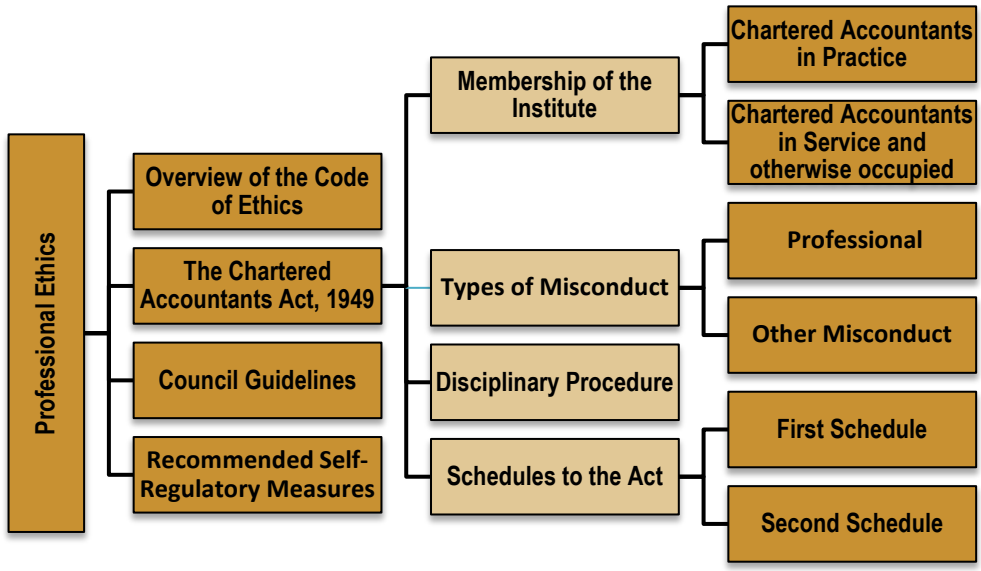
After reading this chapter student shall be able to:

- Understand the application of the International and Indian Code of Ethics theoretically/practically.
- Learn the application of Fundamental Principles of Professional Ethics by Professional Accountants in practice, service or otherwise occupied.
- Identifying threats and safeguards measures while compliance of Fundamental Principles of Professional Ethics.

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CHAPTER OVERVIEW

This chapter encapsulates the relevant professional ethics guidelines, requirements and the standards of conduct expected from a Chartered Accountant. The Chapter has been divided into various sections to facilitate systematic and easy learning by the students.



CA R is one of the leading practitioners in Varanasi and is a partner in an audit firm consisting of 8 partners. The firm is allotted branch audit of a leading public sector bank in the same city having advances of ₹450 crore. The advanced portfolio of the branch consists of some reputed export firms.

It is noticed during audit that drawing power in stock statements submitted to bankers by these firms is not arrived at properly. There are no apparent errors as such. The issue he is raising can be overlooked, if he chooses to do so. Besides, his staff also digs out certain frivolous procedural irregularities in relation to these accounts. The accounts of all these firms are, otherwise, operating satisfactorily. He intends to report these accounts as NPAs in memorandum of changes and is creating headache for AGM every other day. Completion of audit is being delayed on one pretext or another. Even informal calls by Circle DGM prove to be futile. The amounts involved are huge and much is at stake for branch management.

Frustrated and harassed AGM of branch advises owners of these firms to meet CA R in his office and sort out the matter themselves. Out of 7 such firms, 3 owners meet him in his office and assure to avail services of his firm in immediate future. They also try to assuage his ego. He leaves out these accounts from reporting. Owners of the remaining firms do not meet him. Peeved by this, their loan accounts are reported as NPA and adverse comments are made in LFAR.

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Is Chartered Accountant acting ethically? The answer is resounding NO. He is trying to put his personal benefit and interest above all things. He is overlooking certain matters falling in his discretion selectively for obvious reasons. He is not looking at things objectively. A distinguishing feature of Chartered Accountancy profession is the acceptance of responsibility to act in public interest. Such a behavioural attitude is not expected from professionals. Ethics is something which comes from an individual intrinsically. It has to be ingrained in the temperament of an individual to withstand any selfish motive or temptation. It is a state of mind to act and perform in accordance with moral principles. Spirit of ethics is to be followed and not only what is expressly stated or codified.

Consider another case of a practicing Chartered Accountant who comes to know of certain information by virtue of his association with a client. He is also dealing with another client in same line of business. Can he use information acquired from first client to advantage or disadvantage of second client? Again, the answer would be in negative. As he could breach confidentiality by doing so. It can lead to conflict of interest. A professional accountant is not supposed to allow a conflict of interest to compromise professional or business judgment.

Professional work of accountants could involve ethical situations on a daily basis consisting of perceived benefits, pressures or dilemmas. There could be a thin line of difference between ethical and unethical. It requires judgment in every situation in accordance with spirit of ethics and its principles.

Exhaustive code of ethics is in place for public accountants. It not only contains fundamental principles governing professional ethics along with conceptual framework but also deals with independence requirements for assurance engagements. Besides, there are specific provisions of the Chartered Accountants Act, 1949 dealing with professional misconduct.

1. INTRODUCTION

The Oxford Dictionary states ethics as "the moral principle that governs a person's behavior or how an activity is conducted". It is the branch of knowledge that deals with moral principles, whereas *"Professional Ethics"* consist of personal, organizational and corporate standards of behaviour expected for professionals.

Chartered Accountants as professionals are engaged in building trust to vast variety of users, whether shareholders, government, banks, investors, employees or others, which imposes a public interest responsibility on their profession. Like other professionals, Chartered Accountants also have some set of code of ethics. **This Code of Ethics establishes ethical requirements for Professional Accountants.**

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A Chartered Accountant, either in practice or in service, has to abide by these ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their jobs. Service users of professionals should be able to feel secure that there exists a framework of professional ethics which governs the provision of those services. Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants.



Fig: Professional Ethics*

Code of Ethics– Its Necessity: Ethics are as old as human civilization. It is nothing but the laws or rules of acceptable behaviour. The whole foundation of any profession, particularly CA profession, is its credibility. The sole purpose of Code of Ethics is to ensure and uphold this credibility. The main ingredient of our profession is independence. An auditor needs to be independent while carrying out his audit. The provisions discussed in the same ensure that the independence of members of the Institute is not affected.

Our Institute's Motto – ***'Ya Esha Supteshu Jagrati'*** is adopted from Kathopanishad and it denotes 'eternal vigilance' – awakening when the world is asleep.

A distinguishing feature of the accountancy profession is its acceptance of the responsibility to act in the public interest. The Code of Ethics seeks to protect the interests of the profession as a whole. It is a shield that enables us to command respect.

2. OVERVIEW OF THE CODE OF ETHICS

The revised Code of Ethics contains the following material:

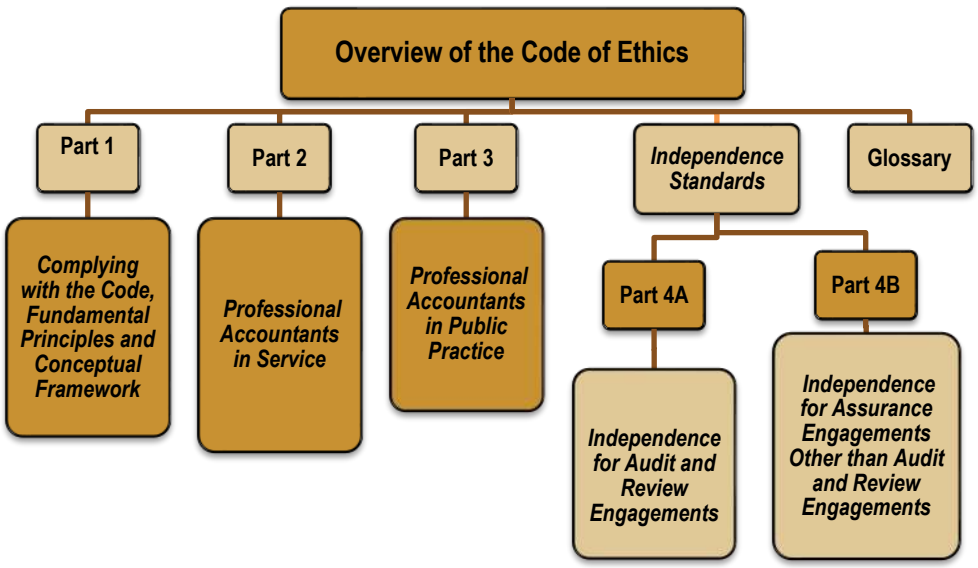
- **Part 1 –** Complying with the Code, Fundamental Principles and Conceptual Framework, which includes the fundamental principles and the conceptual framework and is applicable to all professional accountants.
- **Part 2 –** Professional Accountants in Service, which sets out additional material that applies to professional accountants in service when performing professional activities. Professional accountants in service include professional accountants employed, engaged or contracted in an executive or non-executive capacity in, for example:
    - Commerce, industry or service.
    - The public sector.
    - Education.

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- The not-for-profit sector.
- Regulatory or professional bodies.

Part 2 is also applicable to individuals who are professional accountants in public practice when performing professional activities pursuant to their relationship with the firm as an employee.

- **Part 3 –** Professional Accountants in Public Practice, which sets out additional material that applies to professional accountants in public practice when providing professional services.
  - **Independence Standards,** which sets out additional material that applies to professional accountants in public practice when providing assurance services, as follows:
  - **Part 4A – Independence for Audit and Review Engagements,** which applies when performing audit or review engagements.
  - **Part 4B – Independence for Assurance Engagements Other than Audit and Review Engagements,** which applies when performing assurance engagements that are not audit or review engagements.
- **Glossary,** which contains defined terms (together with additional explanations where appropriate) and described terms which have a specific meaning in certain parts of the Code. For example, as noted in the Glossary, in Part 4A, the term "audit engagement" applies equally to both audit and review engagements. The Glossary also includes lists of abbreviations that are used in the Code and other standards to which the Code refers.



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The Code contains sections which address specific topics. Some sections contain subsections dealing with specific aspects of those topics.

Each section of the Code is structured, where appropriate, as follows:

- **Introduction –** sets out the subject matter addressed within the section and introduces the requirements and application material in the context of the conceptual framework. Introductory material contains information, including an explanation of terms used, which is important to the understanding and application of each Part and its sections.
- **Requirements –** establish general and specific obligations with respect to the subject matter addressed.
- **Application material –** provides context, explanations, suggestions for actions or matters to consider, illustrations and other guidance to assist in complying with the requirements.

A professional accountant shall comply with the Code. There might be circumstances where laws or regulations preclude an accountant from complying with certain parts of the Code. In such circumstances, those laws and regulations prevail, and the accountant shall comply with all other parts of the Code.

2.1 Fundamental Principles

In order to achieve the objectives of the Accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles. The fundamental principles as discussed in Code of Ethics of ICAI, to be complied, are given below:



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(a) Integrity – Subsection 111

1. A professional accountant shall comply with the principle of integrity, **which requires an accountant to be straightforward and honest** in all professional and business relationships. Integrity implies fair dealing and truthfulness.

2. A professional accountant shall not knowingly be **associated with** reports, returns, communications or other information where the accountant believes that the information:

   (a) Contains a materially false or misleading statement;

   (b) Contains statements or information provided negligently; or

   (c) Omits or obscures required information where such omission or obscurity would be misleading.

   However, a professional accountant will ***not be considered to be in breach*** of matters mentioned above in paragraph 2 if the professional accountant provides a modified report in respect of such above mentioned matter.

3. When a professional accountant becomes aware of having been associated with information described in paragraph 2, the accountant shall ***take steps to be disassociated*** from that information.

(b) Objectivity- Subsection 112

A professional accountant shall comply with the principle of objectivity, which requires an accountant not to compromise professional or business judgment because of bias, conflict of interest or undue influence of others.

A professional accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

(c) Professional Competence and Due Care – Subsection 113

1. **A professional accountant shall comply with the principle of professional competence and due care,** which requires an accountant to:

   (a) Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and

   (b) act diligently in accordance with applicable technical and professional standards.

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2. **Serving** clients and employing organizations **with professional competence** requires **the exercise of sound judgment** in applying **professional knowledge** and **skill** when undertaking professional activities.

3. **Maintaining professional competence** requires a **continuing awareness** and an **understanding** of relevant **technical, professional and business developments**.

4. **Continuing professional development** enables a professional accountant to **develop** and **maintain** the **capabilities** to perform competently within the professional environment.

5. **Diligence** encompasses the **responsibility to act** in accordance **with the requirements** of an assignment, **carefully, thoroughly** and on a **timely** basis.

6. In **complying** with the **principle of professional competence and due care**, a professional accountant shall take reasonable steps to ensure that those working in a professional capacity under the accountant's authority have appropriate training and supervision.

Where appropriate, a professional accountant shall make clients, the employing organization, or other users of the accountant's professional services or activities, aware of the limitations inherent in the services or activities.

(d) Confidentiality- Subsection 114

1. A professional accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as a result of professional and employment relationships. An accountant shall:

Be alert to the possibility of inadvertent disclosure, including in a social environment, and particularly to a close business associate or an immediate or a close family member;
Maintain confidentiality of information within the firm or employing organization;
Maintain confidentiality of information disclosed by a prospective client or employing organization;
Not disclose confidential information acquired as a result of professional and employment relationships outside the firm or employing organization without proper and specific authority, unless there is a legal or professional duty or right to disclose;
Not use confidential information acquired as a result of professional and employment relationships for the personal advantage of the accountant or for the advantage of a third party;

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Not use or disclose any confidential information, either acquired or received as a result of a professional or employment relationship, after that relationship has ended; and

Take reasonable steps to ensure that personnel under the accountant's control, and individuals from whom advice and assistance are obtained, respect the accountant's duty of confidentiality.

2. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant in the knowledge that the information will not be disclosed to a third party. Nevertheless, the following are circumstances where professional accountants are or might be required to disclose confidential information or when such disclosure might be appropriate:

(a) Disclosure is ***required by law,***



- Production of documents or other provision of evidence in the course of legal proceedings.
- Disclosure to the appropriate public authorities of infringements of the law that come to light.

(b) Disclosure is ***permitted by law and is authorized by the client*** or the employing organisation;

(c) There is a ***professional duty or right to disclose***, when not prohibited by law:

(i) To comply with the requirements of Peer Review or Quality Review of the Institute;

(ii) To **respond** to an inquiry or investigation by a professional or regulatory body;

(iii) To **protect** the professional interests of a professional accountant in legal proceedings; or

(iv) To **comply** with **technical and professional standards**, including ethics requirements.

3. **In deciding whether to disclose confidential information, professional accountants should consider the following points:**

(a) Whether the interests of any party, including third parties whose interests might be affected, could be harmed if the client or employing organization consents to the disclosure of information by the professional accountant;

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(b)	Whether all the relevant information is known and substantiated, to the extent it is practicable; and
(c)	The proposed type of communication, and to whom it is addressed;
(d)	Whether the parties to whom the communication is addressed are appropriate recipients.

4. A professional accountant shall continue to comply with the principle of confidentiality even after the end of the relationship between the accountant and a client or employing organization. When changing employment or acquiring a new client, the accountant is entitled to use prior experience but shall not use or disclose any confidential information acquired or received as a result of a professional or employment relationship.

(e) Professional Behaviour- Subsection 115

1. A professional accountant shall comply with the principle of professional behaviour, which requires an accountant to comply with relevant laws and regulations and avoid any **conduct** that accountant knows or should know might discredit the profession.

   Conduct that might discredit the profession includes conduct that a reasonable and informed third party would be likely to conclude adversely affects the good reputation of the profession.

   A professional accountant shall not knowingly engage in any employment, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles.

2. When promoting himself and his work, a professional accountant shall not bring the profession into disrepute. A professional Accountant is required to conduct his affairs in a manner that he remains outside the boundaries of professional and other misconduct. A professional accountant shall be honest and truthful and should not make:

   (a) Exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or

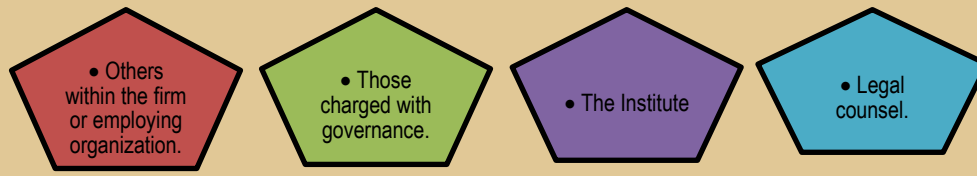
   (b) Disparaging references or unsubstantiated comparisons to the work of others.

   (c) Any direct or indirect measures to advertise any professional/other facts which are in violation of Advertisement Guidelines issued by the Council of the Institute from time to time.

   The professional accountant should ensure that the contents of an advertisement are true to the best of his knowledge and belief, and are in conformity with the Advertisement Guidelines, and be aware that the Institute does not own any responsibility, whatsoever, for such contents

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or claims by him. However, if a professional accountant is in doubt about whether a form of proposed advertising is appropriate, the accountant is encouraged to consult with the Ethical Standards Board of ICAI.

A professional accountant shall comply with each of the fundamental principles.
The fundamental principles of ethics establish the standard of behaviour expected of a professional accountant.
The conceptual framework establishes the approach which an accountant is required to apply to assist in complying with those fundamental principles.
A professional accountant might face a situation in which complying with one fundamental principle conflicts with complying with one or more other fundamental principles. In such a situation, the accountant might consider consulting, with: 
However, such consultation does not relieve the accountant from the responsibility to exercise professional judgment to resolve the conflict or, if necessary, and unless prohibited by law or regulation, disassociate from the matter creating the conflict.
The professional accountant is encouraged to document the substance of the issue, the details of any discussions, the decisions made and the rationale for those decisions.

2.2 Threats, Evaluation of Threats and Safeguards

The conceptual framework specifies an approach for a professional accountant to:

(i) Identify threats to compliance with the fundamental principles;

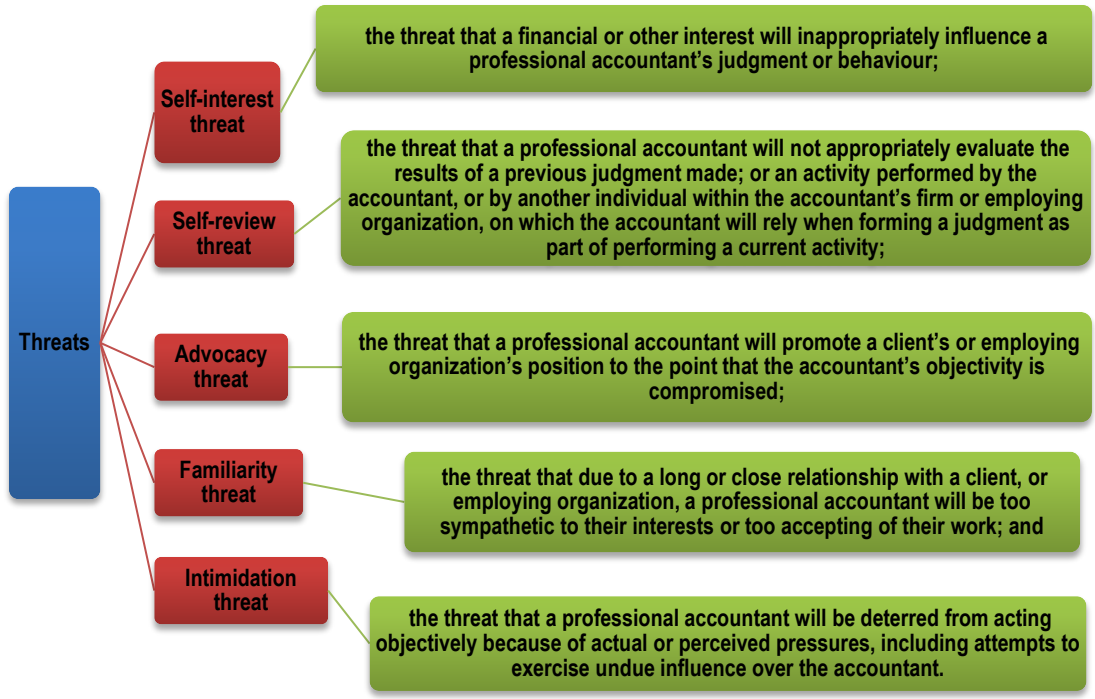
(ii) Evaluate the threats identified; and

(iii) Address the threats by eliminating or reducing them to an acceptable level.

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A. Threats

Threats to compliance with the fundamental principles fall into one or more of the following categories:



A. The following are examples of facts and circumstances within each of those categories of threats that might create threats for a professional accountant when undertaking a professional service:



Self-interest Threats

- A professional accountant having a direct financial interest in a client.
- A professional accountant quoting a low fee to obtain a new engagement and the fee is so low that it might be difficult to perform the professional service in accordance with applicable technical and professional standards for that price.
- A professional accountant having a close business relationship with a client.
- A professional accountant having access to confidential information that might be used for personal gain.
- A professional accountant discovering a significant error when evaluating the results of a previous professional service performed by a member of the **accountant's firm.**

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Self-review Threats

- A professional accountant issuing an assurance report on the effectiveness of the operation of financial systems after implementing the systems.
- A professional accountant having prepared the original data used to generate records that are the subject matter of the assurance engagement.



Advocacy Threats

- A professional accountant promoting the interests of, or shares in, a client.
- A professional accountant acting as an advocate on behalf of a client in litigation or disputes with third parties.
- A professional accountant lobbying in favor of legislation on behalf of a client.



Familiarity Threats

- A professional accountant having a close or immediate family member who is a director or officer of the client.
- A director or officer of the client, or an employee in a position to exert significant influence over the subject matter of the engagement, having recently served as the engagement partner.

An audit team member having a long association with the audit client.



Intimidation Threats

- A professional accountant being threatened with dismissal from a client engagement or the firm because of a disagreement about a professional matter.
- A professional accountant feeling pressured to agree with the judgment of a client because the client has more expertise on the matter in question.
- A professional accountant being informed that a planned promotion will not occur unless the accountant agrees with an inappropriate accounting treatment.
- A professional accountant having accepted a significant gift from a client and being threatened that acceptance of this gift will be made public.

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B. The following are examples of facts and circumstances within each of those categories that might create threats for a professional accountant when undertaking a professional activity:



Self-interest Threats

- A professional accountant holding a financial interest in, or receiving a loan or guarantee from, the employing organization.
- A professional accountant participating in incentive compensation arrangements offered by the employing organization.
- A professional accountant having access to corporate assets for personal use.
- A professional accountant being offered a gift or special treatment from a supplier of the employing organization.



Self-review Threats

- A professional accountant determining the appropriate accounting treatment for a business combination after performing the feasibility study supporting the purchase decision.



Advocacy Threats

- A professional accountant having the opportunity to manipulate information in a prospectus in order to obtain favorable financing.



Familiarity Threats

- A professional accountant being responsible for the financial reporting of the employing organization when an immediate or close family member employed by the organization makes decisions that affect the financial reporting of the organization.
- A professional accountant having a long association with individuals influencing business decisions.



Intimidation Threats

- A professional accountant or immediate or close family member facing the threat of dismissal or replacement over a disagreement about:
  - The application of an accounting principle.
  - The way in which financial information is to be reported.
- An individual attempting to influence the decision-making process of the professional accountant, for example with regard to the awarding of contracts or the application of an accounting principle.

Specific circumstances give rise to unique threats to compliance with one or more of the fundamental principles. Such unique threats cannot be categorized. In either professional or business

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relationships, a professional accountant in public practice should always be on the alert for such circumstances and threats.

B. Evaluation of Threats:

The conditions, policies and procedures described above might impact the evaluation of whether a threat to compliance with the fundamental principles is at an acceptable level.

(i) **Acceptable level:** An acceptable level is a level at which a professional accountant using the reasonable and informed third party test would likely conclude that the accountant complies with the fundamental principles.

(ii) **Reasonable and Informed Third Party:** The reasonable and informed third party test is a consideration by the professional accountant about whether the same conclusions would likely be reached by another party. Such consideration is made from the perspective of a reasonable and informed third party, who weighs all the relevant facts and circumstances that the accountant knows, or could reasonably be expected to know, at the time the conclusions are made. The reasonable and informed third party does not need to be an accountant but would possess the relevant knowledge and experience to understand and evaluate the appropriateness of the accountant's conclusions in an impartial manner.

C. Addressing Threats

If the professional accountant determines that the identified threats to compliance with the fundamental principles are not at an acceptable level, the accountant shall address the threats by eliminating them or reducing them to an acceptable level. The accountant shall do so by:

(i) Eliminating the circumstances, including interests or relationships, that are creating the threats;

(ii) Applying safeguards, where available and capable of being applied, to reduce the threats to an acceptable level; or

(iii) Declining or ending the specific professional activity.

Actions to Eliminate Threats: Depending on the facts and circumstances, a threat might be addressed by eliminating the circumstance creating the threat. However, there are some situations in which threats can only be addressed by declining or ending the specific professional activity. This is because the circumstances that created the threats cannot be eliminated and safeguards are not capable of being applied to reduce the threat to an acceptable level.

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D. Safeguards:

Safeguards are actions individually or in combination that the accountant takes that effectively reduce threats to an acceptable level. Safeguards vary depending on the facts and circumstances. **Examples of actions that in certain circumstances might be safeguards to address threats include:**



- Assigning additional time and qualified personnel to required tasks when an engagement has been accepted might address a self-interest threat.
- Having an appropriate reviewer, who was not a member of the team, review the work performed or advise as necessary might address a self-review threat.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client might address self-review, advocacy or familiarity threats.
- Involving another firm to perform or re-perform part of the engagement might address self-interest, self-review, advocacy, familiarity or intimidation threats.
- Separating teams when dealing with matters of a confidential nature might address a self-interest threat.

2.3 Non-Compliance with Laws and Regulations (NOCLAR)

In the course of providing a professional service to a client or carrying out professional activities for an employer, a Professional accountant may come across an instance of non-compliance with laws and regulations (NOCLAR) or suspected NOCLAR committed or about to be committed **by the client or the employer**, or by those charged with governance, management or employees of the client or employer.

Non-compliance with laws and regulations ("non-compliance") comprises of acts of omission or commission, intentional or unintentional, which are contrary to the prevailing laws or regulations committed by:

- ☐ a client/professional accountant's employing organisation;
- ☐ those charged with governance of a client or employing organisation;
- ☐ management of a client/ employing organisation; or
- ☐ other individuals working for or under the direction of a client/ employing organisation.

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However, NOCLAR under Revised Code of Ethics does not address the personal misconduct unrelated to the business activities of the client/ employing organisation and non-compliance by parties other than listed out in the definition of NOCLAR.

As per IESBA, following examples would be covered in NOCLAR:-

Fraud, corruption and bribery	Money laundering, terrorist financing and proceeds of crime	Securities markets and trading	Banking and other financial products and services
Data protection	Environmental protection	Public health and safety	Tax and pension liabilities and payments

The objective of NOCLAR is that - turning a blind eye to potential NOCLAR is not an appropriate response from professional accountants, while placing renewed emphasis on the roles of management and those charged with governance in addressing the matter. Further, it increases awareness and understanding among Professional accountant of their legal and regulatory responsibilities when they face NOCLAR.

Some important facts about NOCLAR are given below:

During Course of Providing a Service: NOCLAR will be applicable if a professional accountant encounters, or is made aware of, non-compliance or suspected non-compliance in the course of providing a professional service to a client. He is not required to investigate, nor responsible for ensuring compete compliance.

Expertise of Laws not Required: A professional accountant is expected to apply knowledge and expertise, and exercise professional judgment. However, he is not expected to have a level of knowledge of laws and regulations greater than that which is required to undertake the engagement. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body.

Certain Matters Expressly out of Purview: Matters that are clearly inconsequential, or relating to personal misconduct pertaining to business activities of the client not covered.

Disclosure, which is Contrary to Law not Required: As per IESBA Code, disclosure of the matter to an appropriate authority would be precluded if doing so would be contrary to law or regulation.

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2.3.1 Applicability of NOCLAR in India:

1. **Responding to Non-Compliance with Laws and Regulations (NOCLAR) applicable to Professional Accountants in service (Section 260):** Applicable to Senior Professional Accountants in service, being employees of listed entities.

   Senior professional accountants in service ("senior professional accountants") are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and intangible resources.

   It is further explained that the senior professional accountants refer to key managerial personnel.

2. **Responding to Non-Compliance with Laws and Regulations (NOCLAR) applicable to Professional Accountants in public practice (Section 360) :** Applicable to Audit engagements of entities the shares of which are listed on recognized stock exchange(s) in India and have net worth of 250 crores of rupees or more.

   "For the purpose of Section-360 "Audit" or "Audit engagement" shall mean a reasonable assurance engagement in which a professional accountant in public practice expresses an opinion whether financial statements give a true and fair view in accordance with an applicable financial reporting framework".

2.3.2 NOCLAR vs. SA 250

1. SA 250 is applicable only on Audit, and not on other Assurance engagements. However, NOCLAR is applicable on professional accountants in service, and in practice.

2. SA 250 talks of auditor's responsibilities for laws having direct effect on the determination of material amounts and disclosures in the financial statements (such as tax and labour laws); and other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business. NOCLAR, while being alike to SA 250 till this point, is further ahead of it in that it takes into account non-compliance that causes substantial harm resulting in **serious consequences in financial or non-financial terms.**

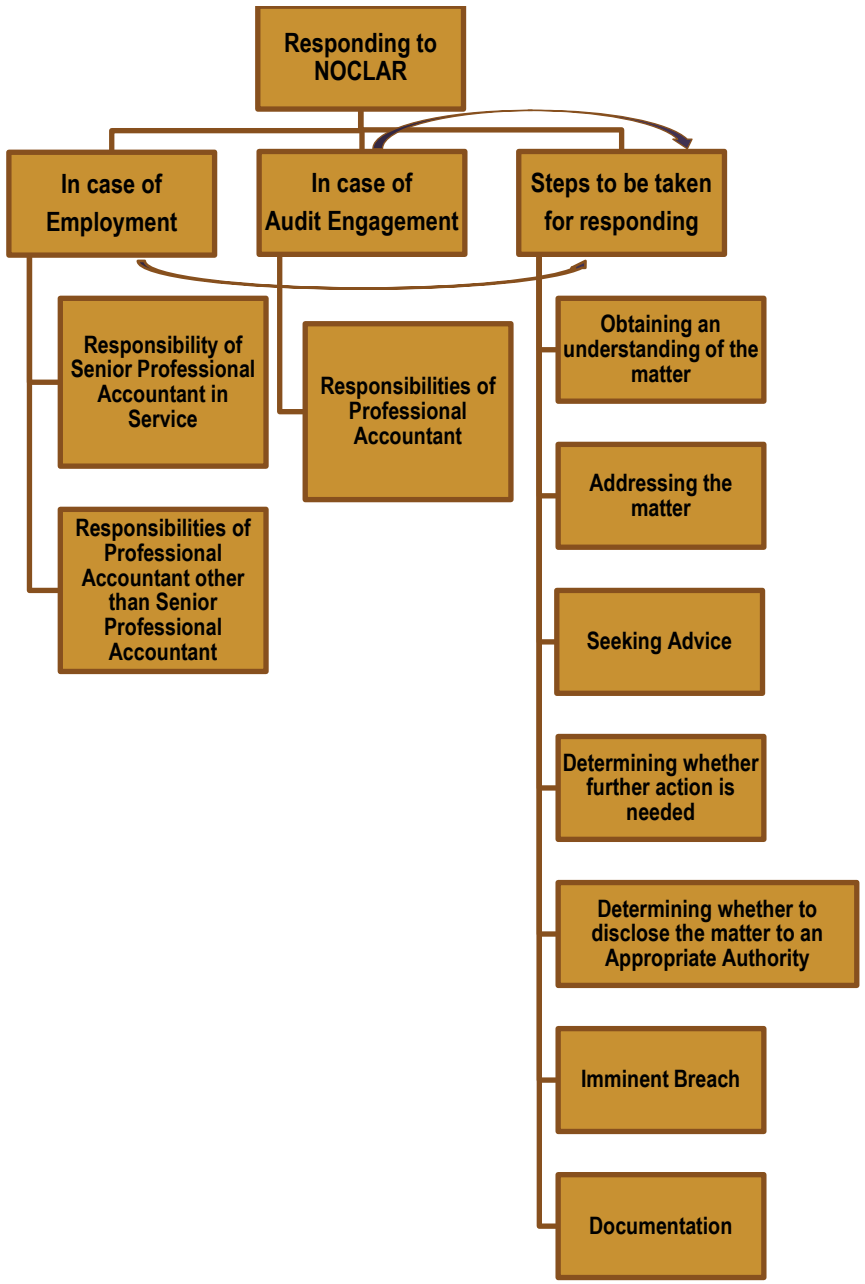
3. SA 250 does not define stakeholders. NOCLAR is related to affect of non-compliance on investors, creditors, employees as also the general public.

4. As per NOCLAR, in exceptional circumstances, the professional accountant might become aware of an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having first considered whether it would be appropriate to discuss the matter with management or those charged with governance of

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the company, the accountant shall exercise professional judgment and determine whether to disclose the matter immediately to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach. If disclosure is made, that disclosure is permitted. This provision is not existent in SA 250.

2.3.2 Responding to NOCLAR:



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It may also be noted that in a situation where disclosure ought to be made by the Auditor, the "Appropriate authority" for the purpose of disclosure will depend on the nature of the matter. For example, the appropriate authority would be SEBI in the case of fraudulent financial reporting.

Appropriate alignment has been made in the Code with regard to requirements of Confidentiality, as required under Chartered Accountants Act, 1949.

2.3.3 Provisions of Confidentiality under Chartered Accountants Act, 1949

For Members in practice – Clause (1) of Part -I of Second schedule to The Chartered Accountants Act, 1949 : A chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his client so engaging him, without the consent of his client or otherwise than as required by any law for the time being in force;

For Members in service - Clause (2) of Part-II to the Second Schedule of the Chartered Accountants Act, 1949 : A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer;

Documentation Requirements in NOCLAR :

Revised Code over and above require the professional accountant to follow the additional documents requirements as under:

- How management / those charged with governance have responded to the matter.
- The course of action the accountant considered, the judgments made and the decisions that were taken, having regard to the reasonable and informed third party test.
- How the accountant is satisfied that the responsibility of public interest has been fulfilled.

This documentation is in addition to complying with the documentation requirements under applicable auditing standards. SAs, for example, require a professional accountant performing an audit of financial statements to:

- Prepare documentation sufficient to enable an understanding of significant matters arising during the audit, the conclusions reached, and significant professional judgments made in reaching those conclusions;

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- Document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place; and
- Document identified or suspected non-compliance, and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.

3. MEMBERSHIP OF THE INSTITUTE

On acceptance of application by the Council, the applicant's name shall be entered in the Register and a certificate of membership in the appropriate Form shall be issued to the applicant.

Particulars of the Register: Section 19 of the Chartered Accountants Act, 1949 provides the particulars to be included in the Register about every member of the Institute, namely-

Full name, date of birth, domicile, residential and professional address;	
Date of entry of name in the Register;	Qualifications;
Whether the member holds a COP; and	Any other prescribed particulars.

3.1 Disabilities for the Purpose of Membership

Section 8 of the Chartered Accountants Act, 1949 enumerates the circumstances under which a person is debarred from having his name entered in or borne on the Register of Members, as follows:

(i) If he has not attained the age of 21 years at the time of his application for the entry of his name in the Register of members; or

(ii) If he is of unsound mind and stands so adjudged by a competent court; or

(iii) If he is an undischarged insolvent; or

(iv) If he, being a discharged insolvent, or has not obtained from the court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part; or

(v) If he has been convicted by a competent Court whether within or without India, of an offence involving moral turpitude and punishable with imprisonment or of an offence, not of a technical nature, committed by him in his professional capacity unless in respect of the offence committed he has either been granted a pardon or, on an application made by him in this behalf, the Central Government has, by an order in writing, removed the disability; or

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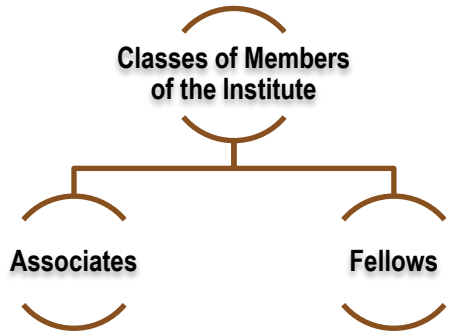
(vi) If he has been removed from membership of the Institute on being found on inquiry to have been guilty of professional or other misconduct;

It may be noted that a person who has been removed from membership for a specified period, shall not be entitled to have his name entered in the Register until the expiry of such period.

In addition, failure on the part of a person to disclose the fact that he suffers from any one of the disabilities aforementioned would constitute professional misconduct. The name of the person, who is found to have been subject at any time to any of the disabilities aforementioned, can be removed from the Register of Members by the Council.

3.2 Types of Members of the Institute

Section 5 of the Chartered Accountants Act, 1949 provides the division of members of the Institute. The members shall be divided into two classes designated as Associates and Fellows.



Associate Member: Any person, whose name has been entered in the Register of members, shall be deemed to have become an Associate of the Institute and shall also be entitled to use the letters A.C.A. after his name to indicate that he is an Associate Member of the Institute.

Fellow Member: The name of following types of members shall be entered into the Register of members as a Fellow of the Institute, on payment of such fees along with the application made and granted in the prescribed manner-

(i) An associate member who has been in continuous practice in India for at least 5 years,

(ii) A member who has been an associate for a continuous period of not less than 5 years and who possesses such qualifications as may be prescribed by the Council with a view to ensuring that he has experience equivalent to the experience normally acquired as a result of continuous practice for a period of 5 years as a Chartered Accountant.

The abovementioned members shall be entitled to use the letters F.C.A. after his name to indicate that he is a Fellow Member of the Institute.

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3.3 Removal of Name from the Register

As per section 20 of the Act, the Council may remove, from the Register, the name of any member of the Institute in the following cases-

(i) who is dead; or

(ii) from whom a request has been received to that effect; or

(iii) who has not paid any prescribed fee required to be paid by him; or

(iv) who is found to have been subject at the time when his name was entered in the Register of members, or who at any time thereafter has become subject, to any of the disabilities mentioned in Section 8, or who for any other reason has ceased to be entitled to have his name borne on the Register.

The Council shall remove the name of any member from the Register in respect of whom an order has been passed under this Act removing him from membership of the Institute.

If the name of any member has been removed from the Register for non-payment of prescribed fee as required to be paid by him, then, on receipt of an application, his name may be entered again in the Register of members on payment of the arrears of annual fee and entrance fee along with such additional fee, as may be determined by the Council.

3.4 Restoration of Membership

In addition to the provisions of the section 20 of the Chartered Accountants Act, 1949 (as discussed in above Para), Regulation 19 of the Chartered Accountants Regulations, 1988, states that the name of the member may be restored by the Council in the Register on an application, in the appropriate Form, received in this behalf whose name has been removed from the Register for non-payment of prescribed fee as required to be paid by him, if he is otherwise eligible to such membership, on his paying the arrears of annual membership fee, entrance fee and additional fee determined by the Council under the Act.

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However, the effective date in case of restoration of cancelled membership, in different situations, shall be in the following manner:

Application for restoration and requisite fees are made within the same year of removal	• Restoration shall be with effect from the date on which it was removed from the Register.
Removal of name under the orders of the Board of Discipline or the Disciplinary Committee or the Appellate Authority or the High Court	• Restoration shall be in accordance with such orders.
In other cases	• Restoration shall be with effect from the date on which the application and fee are received.

3.5 Penalty for Falsely Claiming to be a Member etc.

Section 24 of the Chartered Accountants Act, 1949 provides that any person who-

(i) not being a member of the Institute;

(a) represents that he is a member of the Institute; or

(b) uses the designation Chartered Accountant;

(ii) being a member of the Institute, but not having a certificate of practice, represents that he is in practice or practices as a Chartered Accountant,

shall be punishable on first conviction with fine which may extend to ₹ 1000, and on any subsequent conviction with imprisonment which may extend to 6 months or with fine which may extend to ₹ 5,000, or with both.

The provision may be understood with a case, where, the Court of Additional Chief Judicial Magistrate had by its judgement found the accused guilty under Section 24(i)(a) & (b) of the Chartered Accountants Act, 1949 and Section 465 of the Indian Penal Code. The Court imposed a fine on the accused and in the event of his failure to pay the fine, sentenced to rigorous imprisonment for three months. (Case of Prem Batra decided on 18.7.1989)

4. CHARTERED ACCOUNTANTS IN PRACTICE

A practicing Chartered Accountant is a person who is a member of the Institute and is holding Certificate of Practice; and includes such members of the Institute who are deemed to be in Practice in accordance with the provisions of the Chartered Accountants Act, 1949.

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4.1 Significance of the Certificate of Practice

Section 6 of the Chartered Accountants Act, 1949 provides that**: -**

(1) No member of the Institute shall be entitled to practise whether in India or elsewhere unless he has obtained from the Council a certificate of practice:

It may be noted that this provision is not applicable to any person who, immediately before the commencement of this Act, has been in practice as a registered accountant or a holder of a restricted certificate until one month has elapsed from the date of the first meeting of the Council.

(2) Every such member shall pay such annual fee for his certificate as may be determined, by notification, by the Council [..], and such fee shall be payable on or before the 1st day of April each year

(3) The certificate of practice obtained under sub-section (1) may be cancelled by the Council under such circumstances as may be prescribed.

A member who is not in practice is precluded from accepting engagement to render services of any of the types normally prescribed for a Chartered Accountant, even though for doing so, he does not require special qualifications.

The Council of the institute is of view that-

(i) Once the person concerned becomes a member of the Institute, he is bound by the provisions of the Chartered Accountants Act and its Regulations. If and when he appears before the Income-tax Tribunal as an Income-tax representative after having become a member of the Institute, he could so appear only in his capacity as a Chartered Accountant and a member of the Institute. Having, as it were, brought himself within the jurisdiction of the Chartered Accountants Act and its Regulations, he could not set them at naught by contending that even though he continues to be a member of the Institute and has been punished by suspension from practice as a member, he would be entitled, in substance, to practice in some other capacity.

(ii) A member of the Institute can have no other capacity in which he can take up such practice, separable from his capacity to practice as a member of the Institute."

Therefore, in nutshell, **a Chartered Accountant whose name has been removed from the membership for professional and/or other misconduct, during such period of removal, will not appear before the various tax authorities or other bodies before whom he could have appeared in his capacity as a member of this Institute.**

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Illustration 1

A Chartered Accountant in practice has been suspended from practice for a period of 6 months and he had surrendered his Certificate of Practice for the said period. During the said period of suspension, though the member did not undertake any audit assignments, he undertook representation assignments for income tax whereby he would appear before the tax authorities in his capacity as a Chartered Accountant.

Solution

Undertaking Tax Representation Work: A chartered accountant not holding certificate of practice cannot take up any other work because it would be violation of the relevant provisions of the Chartered Accountants Act, 1949.

In case a member is suspended and is not holding Certificate of Practice, he cannot in any other capacity take up any practice separable from his capacity to practice as a member of the Institute. This is because once a person becomes a member of the Institute; he is bound by the provisions of the Chartered Accountants Act, 1949 and its Regulations.

If he appears before the income tax authorities, he is only doing so in his capacity as a chartered accountant and a member of the Institute. Having bound himself by the said Act and its Regulations made there under, he cannot then set the Regulations at naught by contending that even though he continues to be a member and has been punished by suspension, he would be entitled to practice in some other capacity.

Conclusion: Thus, in the instant case, a chartered accountant would not be allowed to represent before the income tax authorities for the period he remains suspended. Accordingly, in the present case he is guilty of professional misconduct.

4.2 Cancellation and Restoration of Certificate of Practice

Regulation 10 provides that a Certificate of Practice (COP) shall be liable for cancellation, if:

(i)	the name of the holder of the certificate is removed from the Register; or
(ii)	the Council is satisfied, after giving an opportunity of being heard to the person concerned, that such certificate was issued on the basis of incorrect, misleading or false information, or by mistake or inadvertence; or
(iii)	a member has ceased to practise; or
(iv)	a member has not paid annual fee for certificate of practice till 30th day of September of the relevant year.

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Where a COP is cancelled, the holder shall surrender the same to the Secretary.

Further, Regulation 11 on restoration of COP states that, on an application made in the approved Form and on payment of such fee, the Council may restore the COP with effect from the date on which it was cancelled, to a member whose certificate has been cancelled due to non-payment of the annual fee for the COP and whose application, complete in all respects, together with the fee, is received by the Secretary before the expiry of the relevant year.

4.3 Members - deemed to be in Practice

Every member of the Institute is entitled to designate himself as a Chartered Accountant. There are two classes of members, those who are in practice and those who are otherwise occupied. In Section 2(2) of the Act, the term deemed "to be in practice" has been defined as follows:

"A member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, or in partnership with members of such other recognised professions as may be prescribed, he, in consideration of remuneration received or to be received.

(i)	engages himself in the practice of accountancy; or
(ii)	offers to perform or performs service involving the auditing or verification of financial transactions, books, accounts or records, or the preparation, verification or certification of financial accounting and related statements or holds himself out to the public as an accountant; or
(iii)	renders professional services or assistance in or about matters of principle or detail relating to accounting procedure or the recording, presentation or certification of financial facts or data; or
(iv)	renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice;

and the words "to be in practice" with their grammatical variations and cognate expressions shall be construed accordingly.

Explanation – An associate or a fellow of the Institute who is a salaried employee of a Chartered Accountant in practice or a firm of such Chartered Accountants or firm consisting of one or more chartered accountants and members of any other professional body having prescribed qualifications shall, notwithstanding such employment, be deemed to be in practice for the limited purpose of the training of Articled Assistants".

Pursuant to Section 2(2)(iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

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The expression "Management Consultancy and other Services" shall not include the function of statutory or periodical audit, tax (both direct taxes and indirect taxes) representation or advice concerning tax matters or acting as liquidator, trustee, executor, administrator, arbitrator or receiver, but shall include the following-

(i)	Financial management planning and financial policy determination.*
(ii)	Capital structure planning and advice regarding raising finance.*
(iii)	Working capital management.*
(iv)	Preparing project reports and feasibility studies.*
(v)	Preparing cash budget, cash flow statements, profitability statements, statements of sources and application of funds etc.
(vi)	Budgeting including capital budgets and revenue budgets.
(vii)	Inventory management, material handling and storage.
(viii)	Market research and demand studies.
(ix)	Price-fixation and other management decision making.
(x)	Management accounting systems, cost control and value analysis.
(xi)	Control methods and management information and reporting.
(xii)	Personnel recruitment and selection.
(xiii)	Setting up executive incentive plans, wage incentive plans etc.
(xiv)	Management and operational audits.
(xv)	Valuation of shares and business and advice regarding amalgamation, merger and acquisition. Acting as Registered Valuer under the Companies Act, 2013 read with The Companies (Registered Valuers and Valuation) Rules, 2017. (incorporated pursuant to decision of Council at its 388th Meeting)
(xvi)	Business Policy, corporate planning, organisation development, growth and diversification.
(xvii)	Organisation structure and behaviour, development of human resources including design and conduct of training programmes, work study, job-description, job evaluation and evaluation of workloads.
(xviii)	Systems analysis and design, and computer related services including selection of hardware and development of software in all areas of services which can otherwise be

* Consideration of "tax implications" while rendering the services at (i), (ii), (iii) and (iv) above will be considered as part of "Management Consultancy and other services".

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	rendered by a Chartered Accountant in practice and also to carry out any other professional services relating to EDP.
(xix)	Acting as advisor or consultant to an issue, including such matters as:
(a)	Drafting of prospectus and memorandum containing salient features of prospectus. Drafting and filing of listing agreement and completing formalities with Stock Exchanges, Registrar of Companies and SEBI.
(b)	Preparation of publicity budget, advice regarding arrangements for selection of (i) ad-media, (ii) centres for holding conferences of brokers, investors, etc., (iii) bankers to issue, (iv) collection centres, (v) brokers to issue, (vi) underwriters and the underwriting arrangement, distribution of publicity and issue material including application form, prospectus and brochure and deciding on the quantum of issue material (In doing so, the relevant provisions of the Code of Ethics must be kept in mind).
(c)	Advice regarding selection of various agencies connected with issue, namely Registrars to Issue, printers and advertising agencies.
(d)	Advice on the post issue activities, e.g., follow-up steps which include listing of instruments and dispatch of certificates and refunds, with the various agencies connected with the work. *Explanation* - For removal of doubts, it is hereby clarified that the activities of broking, underwriting and portfolio management are not permitted.
(xx)	Investment counselling in respect of securities [as defined in the Securities Contracts (Regulation) Act, 1956 and other financial instruments.] (In doing so, the relevant provisions of the Code of Ethics must be kept in mind).
(xxi)	Acting as registrar to an issue and for transfer of shares/other securities. (In doing so, the relevant provisions of the Code of Ethics must be kept in mind).
(xxii)	Quality Audit.
(xxiii)	Environment Audit.
(xxiv)	Energy Audit.
(xxv)	Acting as Recovery Consultant in the Banking Sector.
(xxvi)	Insurance Financial Advisory Services under the Insurance Regulatory & Development Authority Act, 1999, including Insurance Brokerage.
(xxvii)	Acting as Insolvency Professional in terms of Insolvency and Bankruptcy Code, 2016 (incorporated pursuant to decision of Council at its 362nd Meeting).
(xxviii)	Administrative Services. (incorporated pursuant to decision of Council at its 388th Meeting) Administrative services involve assisting clients with their routine or mechanical tasks within the normal course of operations. Such services require little to no professional judgment and are clerical in nature.

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Examples of administrative services include:



- Word processing services.
- Preparing administrative or statutory forms for client approval.
- Submitting such forms as instructed by the client.
- Monitoring statutory filing dates, and advising an audit client of those dates.



For example, the functions of a GST practitioner as specified under Rule 83(8) of Central Goods and Services Tax Rules, 2017:-

(a) furnish the details of outward and inward supplies;

(b) furnish monthly, quarterly, annual or final return;

(c) make deposit for credit into the electronic cash ledger;

(d) file a claim for refund;

(e) file an application for amendment or cancellation of registration;

(f) furnish information for generation of e-way bill;

(g) furnish details of challan in form GST ITC-04;

(h) file an application for amendment or cancellation of enrolment under rule 58; and

(i) file an intimation to pay tax under the composition scheme or withdraw from the said scheme.

Pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949, read with Regulation 191 of the Chartered Accountants Regulations, 1988 a member shall be deemed to be in practice if he, in his professional capacity and neither in his personal capacity nor in his capacity as an employee, acts as a liquidator, trustee, executor, administrator, arbitrator, receiver, adviser or representative for costing, financial or taxation matters or takes up an appointment made by the Central Government or a State Government or a court of law or any other legal authority or acts as a Secretary unless his employment is on a salary-cum-full-time basis.

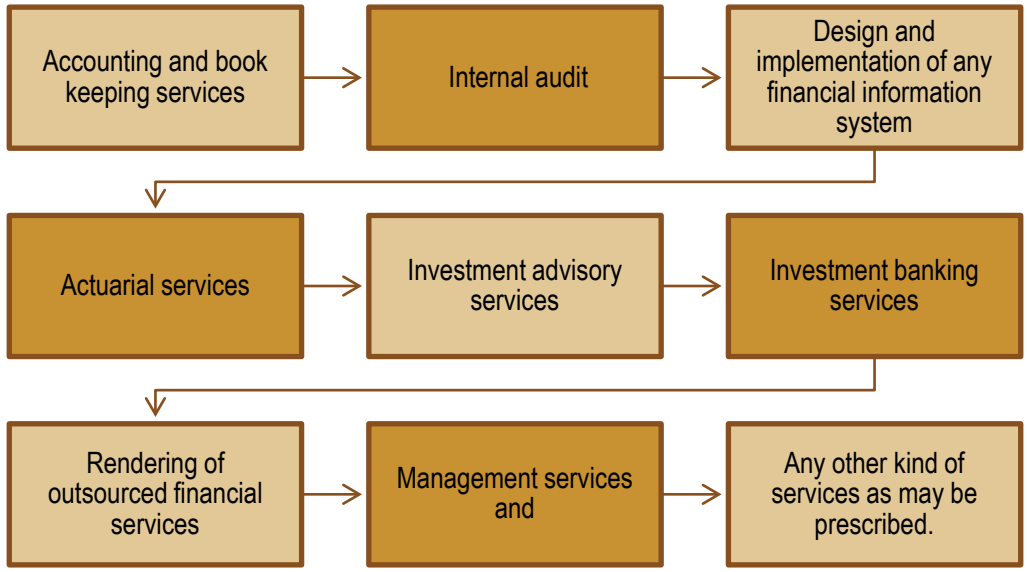
It is necessary to note that a person is deemed to be in practice not only when he is actually engaged in the practice of accountancy but also when he offers to render accounting services whether or not he in fact does so. In other words, the act of setting up of an establishment offering to perform accounting services would tantamount to being in practice even though no client has been served.

It may also be noted that a member of the Institute is deemed to be in practice during the period he renders 'service with armed forces'.

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The above provisions need to be correlated with the provisions of section 144 of the Companies Act, 2013 which prohibits an auditor of the company from rendering certain services directly or indirectly to the company or its holding company or its subsidiary company.

Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely (i) accounting and book- keeping services; (ii) internal audit; (iii) design and implementation of any financial information system; (iv) actuarial services; (v) investment advisory services; (vi) investment banking services; (vii) rendering of outsourced financial services;(viii) management services; and (ix) any other kind of services as may be prescribed.



Certain services not to be rendered by the Auditor as per section 144 of the Companies Act 2013.

Illustration 2

Mr. A, a practicing Chartered Accountant agreed to select and recruit personnel, conduct training programmes for and on behalf of a client where he is not providing any assurance service. Is this a professional misconduct?

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Solution

Providing Management Consultancy and Other Services: Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2)(iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

The definition of the expression "Management Consultancy and other Services" includes Personnel recruitment and selection. Personnel Recruitment and selection includes development of human resources including designing and conduct of training programmes, work study, job description, job evaluation and evaluations of workloads.

Conclusion: Therefore, Mr. A is not guilty of professional misconduct.

4.4 Companies not to Engage in Accountancy

Section 25 of the Chartered Accountants Act, 1949 provides that:

(1) No company, whether incorporated in India or elsewhere, shall practise as chartered accountants.

Here, the term "company" shall include any limited liability partnership which has company as its partner for the purpose of this section.

(2) If any company contravenes this provision then, without prejudice to any other proceedings which may be taken against the company, every director, manager, secretary and any other officer thereof who is knowingly a party to such contravention shall be punishable with fine which may extend on first conviction to ₹ 1,000 and on any subsequent conviction to ₹ 5,000.

In addition, as per section 141(2) of the Companies Act, 2013, where a firm (including a limited liability partnership) is appointed as an auditor of a company, then, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

Though the LLPs are allowed to be appointed as an auditor in accordance with the Companies Act, 2013, however, it cannot be engaged into practice, if it has company as its partner, as per the Chartered Accountants Act, 1949.

Therefore, it can be inferred that the LLP not having any company as its partner, can be engaged into practicing and thus take audit assignments.

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4.5 Member in Practice Prohibited from using a Designation other than Chartered Accountant

(i) Members of the Institute are now permitted to use the word 'CA' as prefix before their name irrespective of the fact that they are in practice or not.

(ii) Under Section 7 of the Chartered Accountants Act, 1949 a member in practice cannot use any designation other than that of a Chartered Accountant, nor he can use any other description, whether in addition thereto or in substitution therefor, but a member who is not in practice and does not use the designation of a Chartered Accountant may use any other description. Nevertheless a member in practice may use any other letters or description indicating *shall be deemed to prohibit any such person from adding any other description or letters to his name, if entitled thereto, to membership of such other Institute of accountancy, whether in India or elsewhere, as may be recognised in this behalf by the Council, or any other qualification that he may possess, or to prohibit a firm, all the partners of which are members of the Institute and in practice, from being known by its firm name as Chartered Accountants.*

Merchant Banker / Advisor to an issue: The members may apply for and obtain registration as category IV Merchant Banker under the SEBI's rules and regulations and act as Advisor or Consultant to an issue. In client Companies' offer documents and advertisements regarding capital issue, name and address of the Chartered Accountant or firm of Chartered Accountants acting as Advisor or Consultant to the Issue could be indicated under the caption "Advisor/Consultant to the Issue". However, the name and address of such Chartered Accountant/firm of Chartered Accountants should not appear prominently.

Directors of Companies, Members of political parties, position in clubs, etc.: The members of the Institute who are also Directors in Companies, members of Political parties or Chartered Accountants Cells in the political parties, holding different positions in clubs or other organisations are not permitted to mention these positions as these would be violative of the provisions of Section 7 of the Act.

Members who are also Cost Accountants: Though a member cannot designate himself as a Cost Accountant, he can use the letters A.C.M.A (Associate) or F.C.M.A (Fellow) after his name, when he is a member of that Institute.

Permission to mention qualifications of certain Institutions: The members are permitted to mention membership of a foreign Institute of Accountancy, which has been recognized by the Council through a Memorandum of Understanding (MoU) / Mutual Recognition Agreement (MRA) with the said Institute.

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Other Qualifications of the member

With regard to the other qualifications of a member, which he is permitted to mention, the following observations of the Supreme Court in Institute of Chartered Financial Analyst of India (ICFAI) vs Council of the Institute of Chartered Accountants of India (ICAI) dated 16th May, 2007 are relevant:

"The expression 'any other qualification that he may possess', therefore, must be read as qualification other than conferred upon the member by other Institutes of Accountancy. Such qualification of accountancy may be conferred even by other Institutes. But as noticed hereinbefore, an exemption had been granted by reason of a resolution of the Institute in relation to the Institute of Cost and Works Accountants. Furthermore, a degree conferred by any university also is subject to an exemption from the rigour of the provisions of Section 7 of the Act. There cannot, therefore, be any doubt whatsoever that 'the other qualification' would mean a qualification other than granted by an Institute of Accountancy, subject of course to recognition thereof by the Institute."



3. For example, though a member cannot designate himself as a Cost Accountant, he can use the letters A.C.M.A.(Associate) or F.C.M.A. (fellow) after his name, when he is a member of that Institute.

It is improper for a Chartered Accountant to state on his professional documents that he is an Income-tax Consultant, Cost Accountant, Company Secretary, Cost Consultant or a Management Consultant.

Member are allowed to appear before the various authorities including Company Law Board, Income Tax Appellate Tribunal, Sales Tax Tribunal where the law has permitted the same, so far as the designation "Corporate Lawyer" is concerned, the Council was of the view that as per the existing provisions of law, a Chartered Accountant in practice is not entitled to use the designation "Corporate Lawyer".

Further, the members are not permitted to use the initials 'CPA' (standing for Certified Public Accountant) on their visiting cards.

Members of the Institute in practice who are otherwise eligible may also practice as Company Secretaries and/or Cost Accountants. Such members shall, however, not use designation/s of the aforesaid Institute/s simultaneously with the designation "Chartered Accountant".

4.6 Maintenance of Branch Offices

In terms of Section 27 of the Act, if a Chartered Accountant in practice or a Firm of Chartered Accountants has more than one office in India, each one of such offices should be in the separate charge of a member of the Institute. Failure on the part of a member or a firm to have a member in

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charge of its branch and a separate member in case of each of the branches, where there is more than one, would constitute professional misconduct.

However, exemption has been given to members practicing in hill areas subject to certain conditions. The conditions are:

(1)	Such members/firm be allowed to open temporary offices in a city in the plains for a limited period not exceeding 3 months in a year.
(2)	The regular office need not be closed during this period and all correspondence can continue to be made at the regular office.
(3)	The name board of the firm in the temporary office should not be displayed at times other than the period such office is permitted to function as above.
(4)	The temporary office should not be mentioned in the letterheads, visiting cards or any other documents as a place of business of the member/firm.
(5)	Before commencement of every winter it shall be obligatory on the member/firm to inform the Institute that he/it is opening the temporary office from a particular date and after the office is closed at the expiry of the period of permission, an intimation to that effect should also be sent to the office of the Institute by registered post.

Above conditions apply to any additional office situated at a place beyond 50 kms from the municipal limits in which any office is situated.

It is necessary to mention that the Chartered Accountant in-charge of the branch of another firm should be associated with him or with the firm either as a partner or as a paid assistant. If he is a paid assistant, he must be in whole time employment with him.

The requirement of Section 27 in regard to a member being in charge of an office of a Chartered Accountant in practice or a firm of such Chartered Accountants shall be satisfied only if the member is actively associated with such office. Such association shall be deemed to exist if the member resides in the place where the office is situated for a period of not less than 182 days in a year or if he attends the said office for a period of not less than 182 days in a year or in such other circumstances as, in the opinion of the Executive Committee, establish such active association.

However, a member can be in-charge of two offices if they are located in one and the same Accommodation. In this context some of the Council's decisions are as follows:

(1) With regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of Chartered Accountant, provided it is a name-plate or a name-board of an individual member and not of the firm.

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Illustration 3

Mr. X & Mr. Y, partners of a Chartered Accountant Firm, one in-charge of Head Office and another in-charge of Branch at a distance of 80 km. from the municipal limits, puts up a name-board of the firm in both premises and also in their respective residences.

Putting Name Board of the Firm at Residence: *The Council of the Institute has decided that with regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of chartered accountant, provided, it is a name-plate or board of an individual member and not of the firm.*

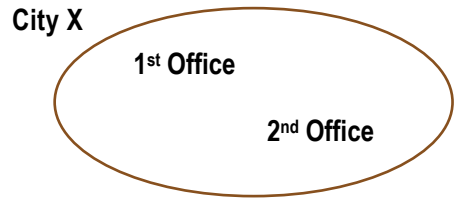
In the given case, partners of XY & Co. put up a name board of the firm in both offices and also in their respective residences.

Conclusion: Thus, the chartered accountants are guilty of misconduct. Distance given in the question is not relevant for deciding.

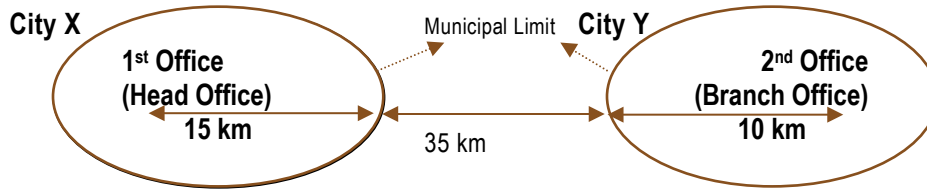
(2) The exemption may be granted to a member or a firm of Chartered Accountants in practice to have a second office without such second office being under the separate charge of a member of the Institute, provided-

(a) the second office is located in the same premises, in which the first office is located or,

(b) the second office is located in the same city, in which the first office is located or,



(c) the second office is located within a distance of 50 km. from the municipal limits of a city, in which the first office is located.



Effective distance from 1st Office = 35 km + 10 km = 45 km

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A member having two offices of the type referred to above shall have to declare, which of the two offices is his main office, which would constitute his professional address.

Illustration 4

Mr. K, Chartered Accountant practicing as a sole proprietor has an office in the suburbs of Chennai. Due to increase in the income tax assessment work, he opens another office near the income tax office, which is within the city and at a distance of 30 km. from his office in the suburb. For running the new office, he has employed a retired Income Tax Commissioner who is not a Chartered Accountant.

Solution

Maintenance of Branch Office in the Same City: As per section 27 of the Chartered Accountants Act, 1949 if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. However, a member can be in charge of two offices if the second office is located in the same premises or in the same city, in which the first office is located; or the second office is located within a distance of 50 km. from the municipal limits of a city, in which the first office is located.

In the given case, Mr. K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in suburbs of Chennai, and due to increase in the work he opened another branch within the city near the income tax office. He also employed a retired income tax commissioner to run the new office, and the second office is situated within a distance of 30 kilometers from his office in the suburb.

Conclusion: In view of the above provisions, there will be no misconduct if Mr. K will be in-charge of both the offices. However, he is bound to declare which of the two offices is the main office.

4.7 KYC Norms for CA in Practice

The financial services industry globally is required to obtain information of their clients and comply with Know Your Client Norms (KYC norms). Keeping in mind the highest standards of Chartered Accountancy profession in India, the Council of ICAI issued such norms to be observed by the members of the profession who are in practice.

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In light of this background, the Council of ICAI approved the following KYC Norms which are mandatory in nature and shall apply in all assignments pertaining to attestation functions.

The KYC Norms approved by the Council of ICAI are given below:

1. Where Client is an Individual/ Proprietor

A. General Information

- Name of the Individual
- PAN No. or Aadhar Card No. of the Individual
- Business Description
- Copy of last Audited Financial Statement

B. Engagement Information

- Type of Engagement

2. Where Client is a Corporate Entity

A. General Information

- Name and Address of the Entity
- Business Description
- Name of the Parent Company in case of Subsidiary
- Copy of last Audited Financial Statement

B. Engagement Information

- Type of Engagement

C. Regulatory Information

- Company PAN No.
- Company Identification No.
- Directors' Names & Addresses
- Directors' Identification No.

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3. Where Client is a Non-Corporate Entity

A. General Information

- Name and Address of the Entity
- Copy of PAN No.
- Business Description
- Partner's Names & Addresses (with their PAN/Aadhar Card/DIN No.)
- Copy of last Audited Financial Statement

B. Engagement Information

- Type of Engagement

5. CHARTERED ACCOUNTANTS IN SERVICE

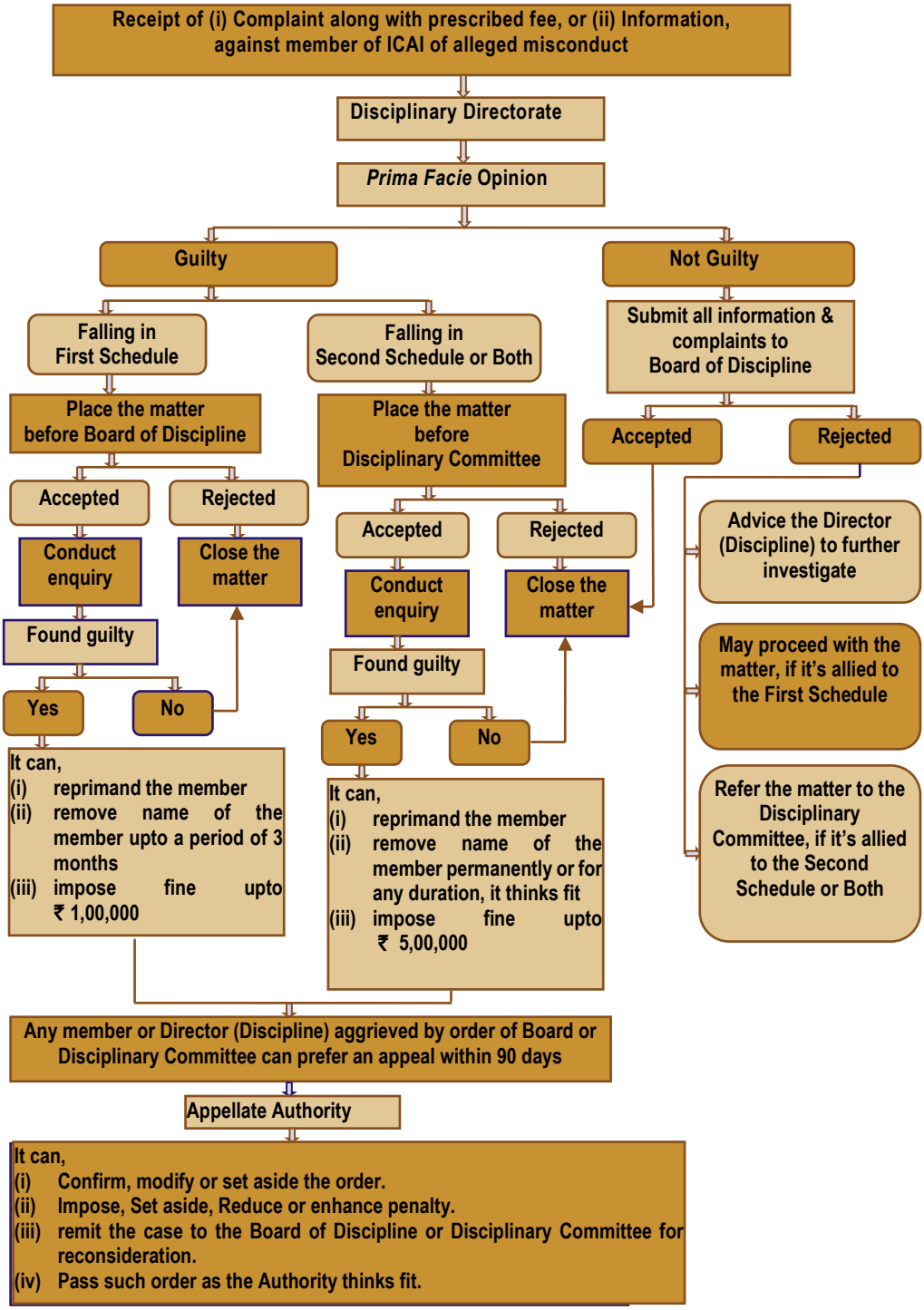
In accordance with the definitions provided under the Code of Ethics, a Professional Accountant in Service or Chartered Accountant in Service means a professional accountant employed or engaged in an executive or non-executive capacity in areas such as commerce, industry, service, the public sector, education, the not-for-profit sector, regulatory bodies or professional bodies, or a professional accountant contracted by such entities.

6 DISCIPLINARY PROCEDURE

Sections 21, 21A, 21B, 21C, 22-A and 22-G of the Chartered Accountants Act read with The Chartered Accountants (Procedure of Investigations of Professional and Other Misconduct of Cases) Rules, 2007 have laid down the following procedure in regard to the investigation of misconduct of members which has been summarized as under:-

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Flow Chart of Discipline Procedure Mechanism



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7 TYPES OF MISCONDUCT: PROFESSIONAL OR OTHER MISCONDUCT

For the purposes of this Act, the expression "professional or other misconduct" shall be deemed to include any act or omission, on the part of any member of the Institute either in his individual capacity or as partner or owner of a firm, as mentioned in any of the Schedules, but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Discipline) under sub-section (1) of section 21 to inquire into the conduct of such member or firm, under any other circumstances.'

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any Professional or Other Misconduct.

7.1 Professional Misconduct

Professional misconduct has been defined in part I, II and III of the First Schedule; and part I and II of the Second Schedule. A member who is engaged in the profession of accountancy whether in practice or in service should conduct/restrict his actions in accordance with the provisions contained in the respective parts of the schedules. If the member is found guilty of any of the acts or omissions stated in any of the respective parts of the Schedule, he/she shall be deemed to be guilty of professional misconduct.

7.2 Other Misconduct

Other misconduct has been defined in part IV of the First Schedule and part III of the Second Schedule. These provisions empower the Council to inquire into any misconduct of a member even it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action.



4. For example, a member who is found to have forged the will of a relative, would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty.

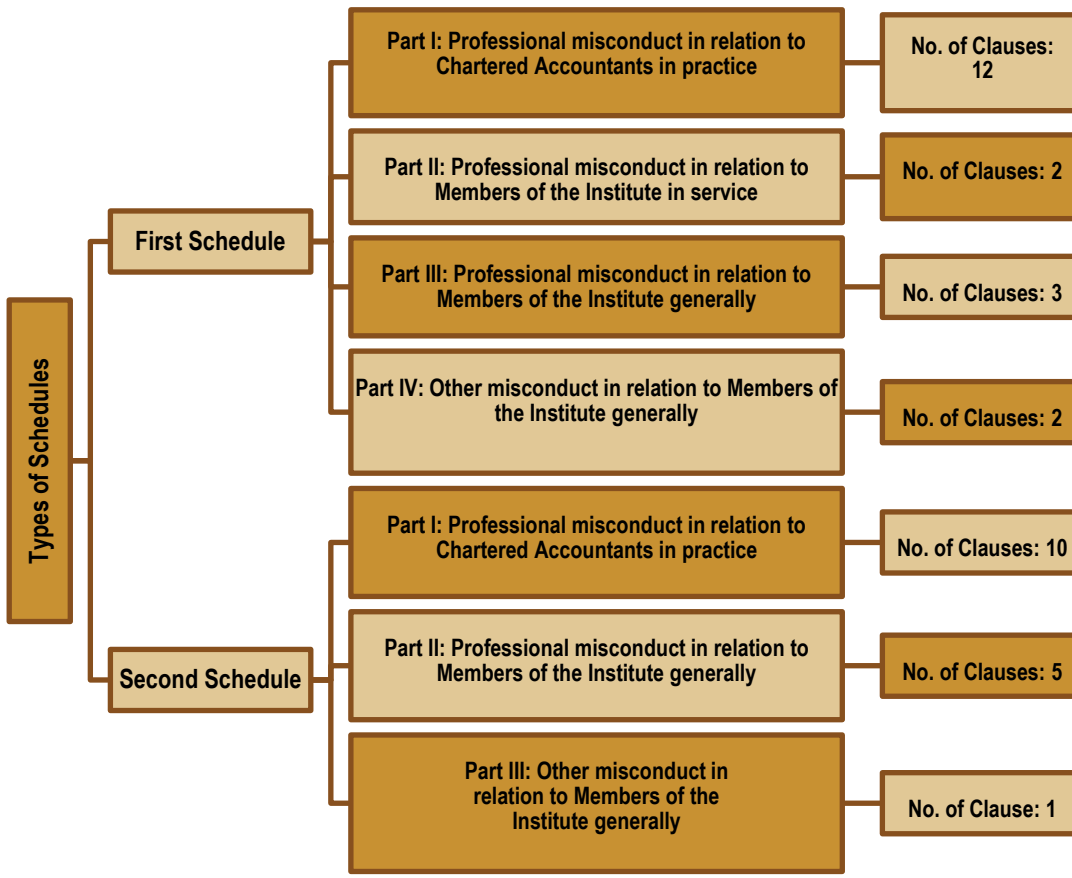
Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with transportation or imprisonment to an offence not of a technical nature committed by the member in his professional capacity. [See section 8(v) of the Act].

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8. SCHEDULES TO THE ACT

Acts or omissions which comprise professional misconduct within the meaning of Section 22 of the Chartered Accountants Act are defined in two Schedules viz. the First Schedule and the Second Schedule. The First Schedule is divided into four parts, Part I of the First Schedule deals with the misconduct of a member in practice which would have the effect generally of compromising his position as an independent person. Part II deals with misconduct of members in services. Part III deals with the misconduct of members generally and Part IV deals with other misconduct in relation to members of the institute generally.

The Second Schedule is divided into three parts. Part I deals with misconduct in relation to a member in practice, Part II deals with misconduct of members generally and Part III deals with other misconduct in relation to members of the Institute generally.



The implications of the different clauses in the schedules are discussed below:

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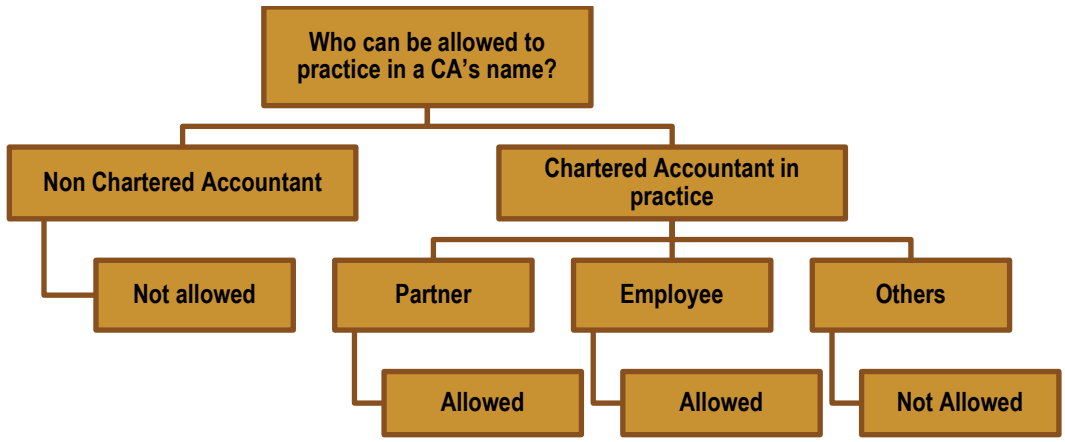
8.1 The First Schedule

Where the Director (Discipline) is of the opinion that member is guilty of any professional or other misconduct mentioned in the First Schedule; he shall place the matter before the Board of Discipline.

PART I - Professional Misconduct in relation to Chartered Accountants in Practice

A Chartered Accountant in practice is deemed to be guilty of professional misconduct if he:

Clause (1): allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him.



The above clause is intended to safeguard the public against unqualified accountant practicing under the cover of qualified accountants. It ensures that the work of the accountant will be carried out by a Chartered Accountant who may be his partner or his employee and would work under his control and supervision.

Illustration 5

C, Chartered Accountant, in practice allowed his brother-in-law Mr. P, who is not a Chartered Accountant, to practice in the name of CA C. He also allowed CA T, who is an employee in his firm to practice in the name. Whether CA C is correct in allowing his brother-in-law Mr. P and CA T employee of his firm to practice in his name.

Solution

Allowing to Practice in a Chartered Accountant's name: As per Clause (1) of Part I to the First Schedule to Chartered Accountants' Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he allows any person to practice in his name as a chartered

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accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him.

In the given situation CA C, Chartered Accountant who is in practice allowed a non-Chartered Accountant, his brother-in-law Mr. P to practice in the name of CA C is not correct in view of Clause 1 of Part I to the First Schedule. However, he can allow CA T who is an employee in his firm to practice in his name.

Conclusion: Thus, CA C will be held guilty of professional misconduct for allowing Mr. P who is not a Chartered Accountant to practice in his name as a chartered accountant as per Clause (1) of Part I to the First Schedule.

Clause (2): pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

Explanation - In this item, "partner" includes a person residing outside India with whom a chartered accountant in practice has entered into partnership which is not in contravention of item (4) of this Part.

It is in order for a member to share his fees or profits with another member of the Institute and/or a firm of Chartered Accountants. A practicing Member of the Institute can share fees or profits arising out of his professional business with such members of other professional bodies or with such other persons having such qualifications as may be prescribed from time to time by the Council.

The Council has prescribed [**Regulation 53A (1)** of the Chartered Accountants Regulations, 1988] the professional bodies, which are as under: -

(a) The Institute of Company Secretaries of India established under the Company Secretaries Act, 1980.

(b) The Institute of Cost & Works Accountants of India established under the Cost & Works Accountants Act, 1959.

(c) Bar Council of India established under the Advocates Act, 1961.

(d) The Indian Institute of Architects established under the Architects Act, 1972.

(e) The Institute of Actuaries of India established under the Actuaries Act, 2006.

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Further, the Council has also prescribed [Regulation 53A (3) of the Chartered Accountants Regulations, 1988] the persons qualified in India, which are as under:

(i) Company Secretary within the meaning of the Company Secretaries Act, 1980;

(ii) Cost Accountant within the meaning of the Cost and Works Accountants Act, 1959;

(iii) Actuary within the meaning of the Actuaries Act, 2006;

(iv) Bachelor in Engineering from a University established by law or an Institution recognised by law;

(v) Bachelor in Technology from a University established by law or an institution recognised by law;

(vi) Bachelor in Architecture from a University established by law or an institution recognised by law;

(vii) Bachelor in Law from a University established by law or an institution recognised by law;

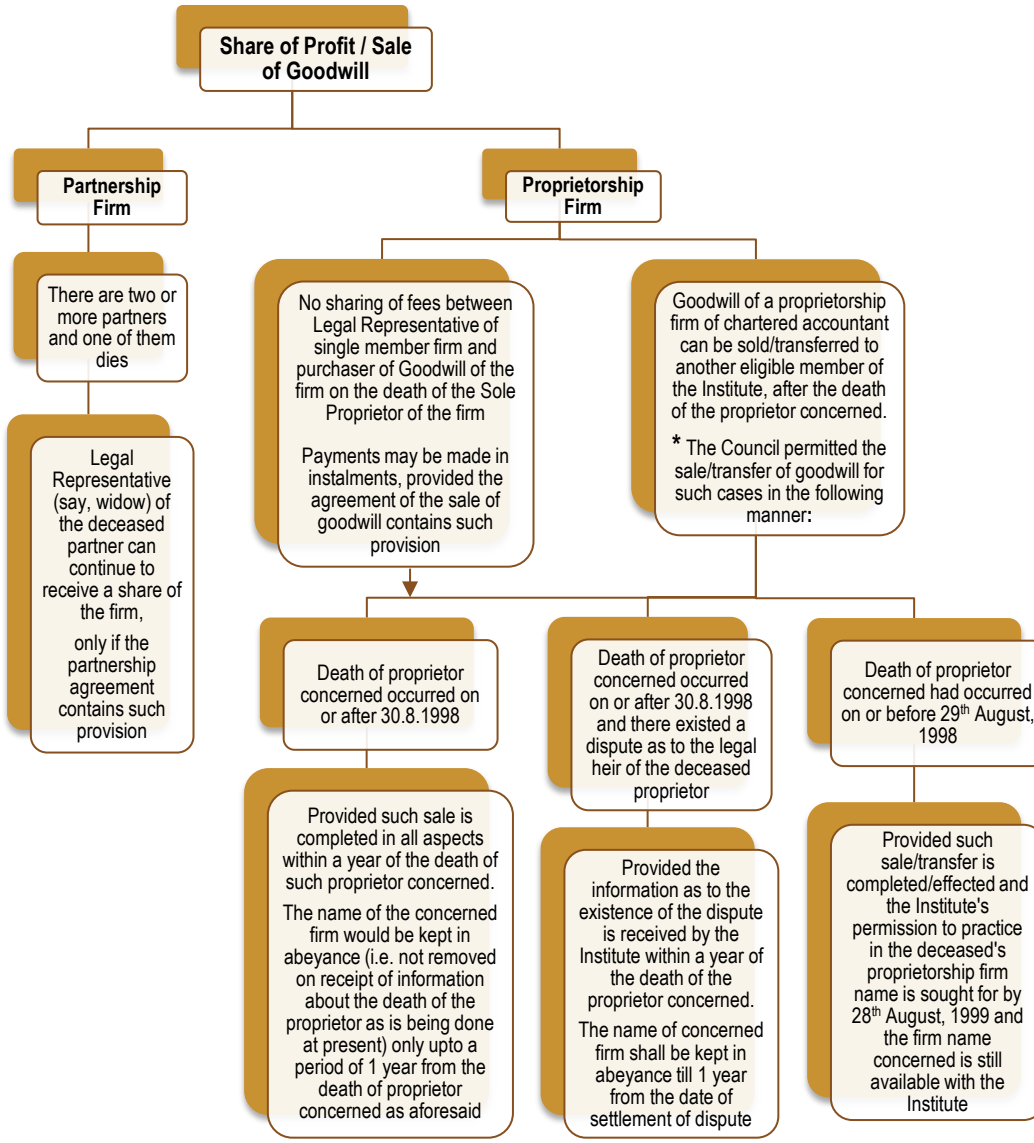
(viii) Master in Business Administration from Universities established by law or technical institutions recognised by All India Council for Technical Education.

The Institute came across certain Circulars/Orders issued by the Registrars of various State Co-operative Societies wherein it has been mentioned that certain amount of audit fee is payable to the concerned State Government and the auditor has to deposit a percentage of his audit fee in the state Treasury by a prescribed challan within a prescribed time of the receipt of Audit fee. The Council considered the issue and while noting that the Government is asking auditors to deposit such percentage of their audit fee for recovering the administrative and other expenses incurred in the process, the Council decided that as such there is no bar in the Code of Ethics to accept such assignment wherein a percentage of professional fee is deducted by the Government to meet the administrative and other expenditure.

Considering the case where a Chartered Accountant gave 50% of the audit fees received by him to the complainant, who was not a Chartered Accountant, under the nomenclature of office allowance and such an arrangement continued for a number of years, it was held by the Council that in substance the Chartered Accountant had shared his profits and, therefore, was guilty of professional misconduct under the clause. It is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

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Treatment of Goodwill –



* In case of a partnership firm when all the partners die at the same time, the above Council decision would also be applicable.

Illustration 6

Mr. Qureshi, Chartered Accountant, in practice died in a road accident. His widow proposes to sell the practice of her husband to Mr. Pardeshi, Chartered Accountant, for ₹ 5 lakhs. The price also includes right to use the firm name - Qureshi and Associates. Can widow of Qureshi sell the practice and can Mr. Pardeshi continue to practice in that name as a proprietor?

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Solution

Sale of Goodwill: With reference to Clause (2) of Part I to the First Schedule to Chartered Accountants' Act, 1949, the Council of the Institute of Chartered Accountants of India considered whether the goodwill of a proprietary concern of chartered accountant can be sold to another member who is otherwise eligible, after the death of the proprietor.

It lays down that the sale is permitted subject to certain conditions discussed in the above flowchart. It further resolved that the legal heir of the deceased member has to obtain the permission of the Council within a year of the death of the proprietor concerned.

Conclusion: Thus, in a given case, the widow of Mr. Qureshi, who has proposed to sell the practice for ₹ 5 lakhs is in effect proposing the sale of goodwill. Thus, the act of Mrs. Qureshi is permissible and Mr. Pardeshi can continue to practice in that name as a proprietor.

Clause (3): accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute.

Provided that nothing herein contained shall be construed as prohibiting a member 'from entering into profit sharing or other similar arrangements, including receiving any share commission or brokerage in the fees, with a member of such professional body or other person having qualifications, as is referred to in item (2) of this part.

Just as a member cannot share his fees with a non-member, he is also not permitted to receive and share the fees of others except for sharing with Member of such professional body or other person having such qualification as may be prescribed (Regulation 53A of the Chartered Accountants Regulations, 1988) by the Council for the purpose of Clause (2), (3) and (5) of Part I of First Schedule. Such a restriction is necessary so that a Chartered Accountant who is often required to engage or to recommend for engagement by his clients, the services of the members of other professions, cannot share the fees received by other persons who are otherwise not permitted by the Council in terms of provision of this clause.

Referral fees amongst members: It is not prohibited for a member in practice to charge Referral Fees, being the fees obtained by a member in practice from another member in practice in relation to referring a client to him.

Clause (4): enters into partnership, in or outside India, with any person other than Chartered Accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under clause (v) of sub-section (1) of section 4 or whose qualifications are recognized by the Central Government or the Council for the purpose of permitting such partnerships.

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The Council has prescribed Regulation 53A (3) (as discussed under clause (2) of this part) and Regulation 53B of the Chartered Accountants Regulations, 1988 for the persons qualified and the professional bodies.

The Regulation 53B prescribes the membership of following professional bodies for entering into partnership:

(a) Company Secretary, member, The Institute of Company Secretaries of India, established under the Company Secretaries Act, 1980;

(b) Cost Accountant, member, The Institute of Cost and Works Accountants of India established under the Cost and Works Accountants Act, 1959;

(c) Advocate, member, Bar Council of India established under the Advocates Act, 1961;

(d) Engineer, member, The Institution of Engineers, or Engineering from a University established by law or an institution recognized by law.

(e) Architect, member, The Indian Institute of Architects established under the Architects Act, 1972;

(f) Actuary, member, The Institute of Actuaries of India, established under the Actuaries Act, 2006.

A Chartered Accountant in practice is not permitted to enter into partnership with any person other than a Chartered Accountant in practice or such other persons as may be prescribed by the Council from time to time. The members may however take note of the fact that they cannot form Multi-Disciplinary partnerships till such time that Regulators of such other professionals also permit partnership with chartered accountants, and guidelines in this regard are issued by the Council.

Clause (5) secures either through the services of a person who is not an employee of such Chartered Accountant or who is not his partner or by means which are not open to a Chartered Accountant, any professional business.

Provided that nothing herein contained shall be construed as prohibiting any agreement permitted in terms of item (2), (3) and (4) of this part.

"A man must stand erect, and not to be kept erect by others", is a dictum by Marcus Aurelius which though applicable for a man in every walk of life is more so in the case of a professional life. A Chartered Accountant must seek work not through any agency, but by the respect, that he is able to command for his professional talent and skill and by the confidence he is able to inspire by his reputation. All forms of canvassing on that account are regarded unethical and are prohibited. The decision of the Council under this clause is given below:

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A Chartered Accountant wrote various letters to officers of different Army Canteens giving details about him and his experience, his partner & office and the norms for charging audit fees. He was held guilty for violation of Clauses (5) & (6). (Jethanand Sharda vs. Deepak Mehta – Council's decision dated 1st to 4th July, 1998 – Page 61 of Volume VIII(2) of Disciplinary Cases).

It may further be noted that the acts of partners and employees of the Firm towards securing professional work are subject to the provisions of Clauses (6) and (7) of Part-I of First Schedule of the Chartered Accountants Act, 1949.

Clause (6) solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Provided that nothing herein contained shall be construed as preventing or prohibiting -

(i) Any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice; or

(ii) A member from responding to tenders or enquiries issued by various users of professional services or organizations from time to time and securing professional work as a consequence.

However, as per the guideline issued by the Council of the Institute of Chartered Accountants of India, a member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for chartered accountants, such as audit and attestation services. However, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.

Further, keeping in view the broad purview of Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, an advertisement of Coaching /teaching activities by a member in practice may amount to indirect solicitation, as well as solicitation by any other means, and may therefore be violative of the provisions of Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

In view of the above, such members are advised to abstain from advertising their association with Coaching / teaching activities through hoardings, posters, banners and by any other means, failing which they may be liable for disciplinary action, as per the provisions of the Chartered Accountants Act, 1949 and Rules/Regulations framed thereunder. However, it may be noted that subject to the above prohibition, such members may put, outside their Coaching/teaching premises, sign board mentioning the name of Coaching/teaching Institute, contact details and subjects taught therein only.

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As regards the size and type of signboard, the Council Guidelines as applicable to Firms of Chartered Accountants would apply.

It is an elaboration of the principle propounded in the preceding clause enjoining that for securing professional work the help of others should not be sought. This clause further enjoins on a member not to solicit professional work by means of advertisement, circular, personal communication or interview or by any other means. The members should not adopt any indirect methods to adventure their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practiced so that members may maintain their independence of judgment and may be able to command the respect of their prospective clients.

The professional work cannot be secured either by advertisement or by circulars or by solicitation. It can only be obtained by a member gradually building confidence in his ability and integrity. The service tendered by an accountant is of a personal and intimate nature and its value can be appraised only by personal contact and experience. A public advertisement is likely to lead to an impression that the professional person is over anxious to win confidence, which however will have the opposite effect. The satisfaction of clients would be the best advertisement, which would lead to other clients. Unabashed advertisement would affect the public esteem in which the profession is held and would act to the disadvantage of its members. An advertisement is not a key to success in the profession. It is the quality service, which attracts and retains the clients.

Some forms of soliciting work which the Council has prohibited are discussed below:

(a) **Advertisement and note in the press –** Members should not advertise for soliciting work or advertise in a manner which could be interpreted as soliciting or offering to undertake professional work. They are also not permitted to use the less open method of circulating letters to a small field of possible clients. Personal canvassing or canvassing for clients of previous employer through the help of the employees are also not permitted. The **exceptions** to the above rule are:

(i) A member may request another Chartered Accountant in practice for professional work.

(ii) a member may advertise changes in partnerships or dissolution of a firm, or of any change in address of practice and telephone numbers. Such announcements should be limited to a bare statement of facts and consideration given to the appropriateness of the area of distribution of the newspaper or magazine and number of insertions.

(iii) a member is also permitted to issue a classified advertisement in the journal/ newsletter of the Institute intended to give information for sharing professional work

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on assignment basis or for seeking partnership or salaried employment of an accountancy nature, provided it only contains the accountant's name, address or telephone number, fax number, e-mail address and address(es) of social Networking sites of members. However, mere factual position of experience and area of specialization, relevant to seek response to the advertisement, are permissible.

(b) **Application for empanelment for allotment of audit and other professional work –** The Government departments, government companies/Corporations, courts, co-operative societies and banks and other similar institutions prepare panels of chartered accountants for allotment of audit and other professional work. Where the existence of such a panel is within the knowledge of a member, he is free to write to the concerned organization with a request to place his name on the panel. **However, it would not be proper for the Chartered Accountant to make roving enquiries by applying to any such organization for having his name included in any such panel.** It is permissible to quote fees on enquiries being received from such bodies, which maintain such panel.

(c) **Responding to Tenders, Advertisements and Circulars:** It is not prohibited to the members to respond to tenders and requests made by users of professional work. This is however subject to conditions that may be issued by the Council from time to time.

The Council has issued Guidelines No. 1-CA(7)/03/2016 dated 7th April 2016 (see **Appendix 'J')** which stipulate that a member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for Chartered Accountants, such as audit and attestation services. However, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants. *The "minimum fee" for this purpose should be such that it commensurates with size, value, volume, manpower requirement and nature of work*.

EMD/Security Deposit: The Council is of the view that while interference with the practices prevailing for requirement of EMD/Deposit is not required. However, on having received complaint/ instance of exorbitant EMD/Deposit, the Ethical Standards Board may look into the matter on case to case basis.

A cost sheet be maintained by members of the Institute responding to tenders, incorporating details of the costs being incurred therein having regard to number of persons involved, hours to be spent, etc, so that the same may be called for by the Institute for perusal.

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(d) **Publication of Books, Articles or Presentation:** It is not permissible for a member to mention in a book or an article published by him, or a presentation made by him, any professional attainment(s), whether of the member or the firm of chartered accountants, with which he is associated. However, he may indicate in a book, article or presentation the designation "Chartered Accountant" as well as the name of the firm.

(e) **Issue of Greeting Cards or Invitations:** The Council does not approve of the issue of greeting cards or personal invitations by members indicating their professional designation, status and qualifications etc. However, the Council is of the view that the designation "Chartered Accountant" as well as the name of the firm may be used in greeting cards, invitations for marriages and religious ceremonies and any invitations for opening or inauguration of office of the members, change in office premises and change in telephone numbers, provided that such greeting cards or invitations etc. are sent only to clients, relatives and friends of the members concerned.

(f) **Advertisement for Silver, Golden, Platinum or Centenary celebrations:** It is not permitted to advertise the events organised by a Firm of Chartered Accountants. However, considering the need of interpersonal socialization/relationship of the members through such get together occasions, the advertisement for Silver, Golden, Diamond, Platinum or Centenary celebrations of the Chartered Accountants Firms may be published in newspaper or newsletter.

(g) **Sponsoring Activities**

(a) A member in practice or a Firm of Chartered Accountants is not permitted to sponsor an event. However, such member or Firm may sponsor an event conducted by a Programme Organizing Unit (PoU) of the ICAI, provided such event has the prior approval of Continuing Professional Education (CPE) Directorate of the ICAI.

(b) Members sponsoring activities relating to Corporate Social Responsibility may mention their individual name with the prefix "CA". However, the mention of Firm name or CA Logo is not permitted.

(h) **Advertisement of Teaching/Coaching activities by members:** The members engaged in teaching /coaching activities, while advertising such teaching /coaching activities, shall comply with the Regulation 190A of the Chartered Accountants Regulations, 1988(discussed in the Chapter in Clause 11).

Keeping in view the broad purview of Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, an advertisement of Coaching /teaching activities by a

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member in practice may amount to indirect solicitation, as well as solicitation by any other means, and may therefore be violative of the provisions of Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

In view of the above, such members are advised to abstain from advertising their association with Coaching /teaching activities through hoardings, posters, banners and by any other means, failing which they may be liable for disciplinary action, as per the provisions of the Chartered Accountants Act, 1949 and Rules/Regulations framed thereunder.

Subject to the above prohibition, such members may put, outside their Coaching/ teaching premises, a sign board mentioning the name of Coaching/teaching Institute, contact details and subjects taught therein only. As regards the size and type of signboard, the Council Guidelines as applicable to Firms of Chartered Accountants would apply.

(i) **Sharing Firm Profile with prospective Client:** It is not permitted to share Firm profile with a prospective Client unless it is in response to a proposed client's specific query, and otherwise not prohibited to be used by the client.

(j) **Television or Movie Credits:** While sharing name of the member or Firm of Chartered Accountants for inclusion in Television or Movie Credits, it must be taken care of that exhibition of name is not made differently as compared to other entries in the credits.

(k) **Soliciting professional work by making roving enquiries:** It is not permissible for a member to address letters, emails or circulars specifically to persons who are likely to require services of a Chartered Accountant since it would tantamount to advertisement.

(l) **Seeking work from Professional Colleagues:** The issue of an advertisement or a circular by a Chartered Accountant, seeking work from professional colleagues on any basis whatsoever except as provided above would be in violation of this clause.

(m) **Scope of representation which an auditor is entitled to make under Section 225(3) of the Companies Act, 1956 (Section 140(4) of the Companies Act, 2013):** The right to make representation does not mean that an auditor has any prescriptive right or a lien to an audit. The wording of his representation should be such that, apart from the opportunity not being abused to secure needless publicity, it does not tantamount directly or indirectly to canvassing or soliciting for his continuance as an auditor. The letter should merely set out in a dignified manner how he has been acting independently and conscientiously through the term of office and may, in addition, indicate if he so chooses, his willingness to continue as auditor if reappointed by the shareholders.

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(n) **Acceptance of original professional work by a member emanating from the client introduced to him by another member:** The Council has decided that a member should not accept the original professional work emanating from a client introduced to him by another member. If any professional work of such client comes to him directly, it should be his duty to ask the client that he should come through the other member dealing generally with his original work.

(o) **Giving Public Interviews:** While giving any interview or otherwise furnishing details about themselves or their firms in public interviews or to the press or at any forum, the members should ensure that, it should not result in publicity. Due care should be taken to ensure that such interviews or details about the members or their firms are not given in a manner highlighting their professional attainments. Any detail which is given must, in addition to meeting the above requirements, be given only as a response to a specific question, and of factual nature only.

(p) **Members and/or firms who publish advertisements under Box numbers:** Members/Firms are prohibited from inserting advertisements for soliciting clients or professional work under box numbers in the newspapers. This practice is in violation of this clause.

(q) **Educational Videos**: While the videos of educational nature may be uploaded on the internet by members, no reference should be made to the Chartered Accountants Firm wherein the member is a partner/ proprietor. Further, it should not contain any contact details or website address.

Illustration 7

Mr. S, a Chartered Accountant published a book and gave his personal details as the author. These details also mentioned his professional experience.

Soliciting Professional Work: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 refers to professional misconduct of a member in practice if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means. Therefore, members should not adopt any indirect methods to advertise their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practiced so that members may maintain their independence of judgement and may be able to command the respect of their prospective clients. While elaborating forms of soliciting work, the Council has specified that a member is not permitted to indicate in a book or an article, published by him, his association with any firm of chartered accountants. In this case, Mr. S, a Chartered Accountant published the book and mentioned his professional experience in detail in the same.

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Conclusion: Mr. S being a chartered accountant in practice has committed the professional misconduct by mentioning his professional experience.

Illustration 8

M/s XYZ, a firm of Chartered Accountants created a website "www.xyzindia.com". The website besides containing details of the firm and bio-data of the partners also contains the passport size photographs of all the partners of the firm.

Hosting Details on Website: As per detailed guidelines of the ICAI laid down in Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant of the firm can create its own website using any format subject to guidelines. However, the website should be so designed that it does not solicit clients or professional work and should not amount to direct or indirect advertisement. The guidelines of the ICAI to allow a firm to put up the details of the firm, bio-data of partners and display of a passport size photograph.

Conclusion: In the case of M/s XYZ, all the guidelines seem to have been complied and there appears to be no violation of the Chartered Accountants Act, 1949 and its Regulations.

Illustration 9

M/s LMN, a firm of Chartered Accountants responded to a tender from a State Government for computerization of land revenue records. For this purpose, the firm also paid ₹ 50,000 as earnest deposit as part of the terms of the tender.

Responding to Tenders: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits. However, on having received complaint/ instance of exorbitant EMD/Deposit, the Ethical Standards Board may look into the matter on case to case basis.

Conclusion: In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s LMN can respond to tender as well as deposit ₹ 50,000 as earnest deposit and shall not have committed any professional misconduct.

Illustration 10

Mr. Honest, a Chartered Accountant in practice, wrote two letters to M/s XY Chartered Accountants a firm of CAs; requesting them to allot him some professional work. As he did not have a significant practice or clients he also wrote a letter to M/s ABC, a firm of Chartered Accountants for securing professional work. Mr. Clever, another CA, informed ICAI regarding Mr. Honest's approach to secure the professional work. Is Mr. Honest wrong in soliciting professional work?

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Securing Professional Work: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Provided that nothing herein contained shall be construed as preventing or prohibiting any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice.

Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

Conclusion: In the given case, Mr. Honest wrote letters only to other Chartered Accountants, M/s XY and M/s ABC requesting them to allot some professional work to him, which is not prohibited under Clause (6) as explained above. Thus, Mr. Honest has not committed any professional misconduct by soliciting professional work.

Clause (7) advertises his professional attainments or services, or uses any designation or expressions other than the Chartered Accountant on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a University established by law in India or recognized by the Central Government or a title indicating membership of the Institute of Chartered Accountants or of any other institution that has been recognized by the Central Government or may be recognized by the Council.

Provided that a member in practice may advertise through a write up, setting out the service provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council.

This clause prohibits advertising of professional attainments or services of a member. However, the services can be advertised in a restricted way through a write up subject to the Guidelines of the Council issued from time to time. Refer chapter 3 of the book. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public.

Other Designations: It is improper for a Chartered Accountant in practice to state on his professional documents that he is an Income-tax Consultant, Cost Accountant, Company Secretary, Cost Consultant or a Management Consultant.

While noting that it had already allowed its members to appear before the various authorities including Company Law Board, Income Tax Appellate Tribunal, Sales Tax Tribunal where the law

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has permitted the same, so far as the designation "Corporate Lawyer" is concerned, the Council was of the view that as per the existing provisions of law, a Chartered Accountant in practice is not entitled to use the designation "Corporate Lawyer".

A member must not use the designation such as 'Member of Parliament', 'Municipal Councilor' nor any other functionary in addition to that of Chartered Accountant.

A member empanelled as Insolvency Professional or Registered Valuer can mention "Insolvency Professional" or "Registered Valuer" respectively on his visiting card and letter head.

Permission to mention qualifications of certain Institutions: The members are permitted to mention a title on their visiting cards to indicate membership of a foreign Institute of Accountancy, which has been recognised by the Council e.g. South African Institute of Chartered Accountants (SAICA), Institute of Certified Public Accountants (CPA Ireland) and Institute of Chartered Accountants in England and Wales (ICAEW).

Date of setting-up practice: The date of setting up the practice by a member or the date of establishment of the firm on the letter heads and other professional documents etc. should not be mentioned.

Practice as Advocate: Members of the Institute in practice who are otherwise eligible may practise as advocates subject to the permission of the Bar Council but in such case, they should not use designation 'Chartered Accountant' in respect of the matters involving the practice as an advocate. In respect of other matters, they should use the designation 'Chartered Accountant' **but they should not use the designation 'Chartered Accountant' and 'Advocate' simultaneously.**

Practice as Company Secretary/Cost Management Accountant: Members of the Institute in practice who are otherwise eligible may also practice as Company Secretaries and/or Cost Management Accountants. Such members shall, however, not use designation/s of the aforesaid Institute/s simultaneously with the designation "Chartered Accountant".

It is clarified that in the event of the permission being granted to a member in practice to also hold COP of sister Institute(s)/Bar Council, such a member be treated as a member in full-time practice.

Mention of Firm name except on Professional Documents: It is not proper for a Firm of Chartered Accountants to use the designation 'Chartered Accountant' except on professional documents, visiting cards, letter heads or sign boards and under the circumstances clarified under Clause (6). However, an individual member may use the prefix "CA" with his name.

Notice in the Press relating to the Success in an Examination: Notice in the press relating to the success in an examination of an individual candidate, should not contain any element of

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undesirable publicity either in relation to the articled/audit assistant or an employee or the member or the firm with whom he was served.

It is usual for local papers to publish details of the examination success of local candidates. Some biographical information is often included. The rule aforementioned is not intended to discourage the printing of news of local interest but is intended to indicate the need for restraint. The candidate's name and address, school and local background, examination passed with details of any prize or place gained, the name of the principal, firm and town in which the principal practices may be published.

Reports and Certificates: The reports and certificates issued by a Chartered Accountant bring him to the notice of the public in a greater or lesser degree. It is therefore incumbent upon him to ensure that the extent and manner of publication of certificates are limited to what is necessary to enable the report or certificate to serve its proper purpose. The members may however note that they should use letterhead of their Firm for issuing reports and certificates.

Appearance of Chartered Accountants on Electronic Media (including Internet): Members may appear on television, films and Internet and agree to broadcast in the Radio or give lectures at forums and may give their names and describe themselves as Chartered Accountants. Special qualifications or specialised knowledge directly relevant to the subject matter of the programme may also be given. Firm name may also be mentioned, however, any exaggerated claim or any kind of comparison is not permissible. What he may say or write must not be promotional of him or his firm but must be an objective professional view of the topic under consideration.

Publicity is permitted for appointments to positions of local or national importance or for the views of members on matters of similar importance. Mention of the membership of the Institute is desirable in such cases. What should be aimed at is to achieve suitable publicity for the Institute and its members generally. Members giving talks or lectures or attending conference may describe themselves as Chartered Accountants only when they are acting in their capacity as Chartered Accountants. However, reference to the professional firm of the member should not be given.

Organising Training Courses, Seminars etc. for his staff: A Chartered Accountant in practice holding training courses, seminars etc. for his staff may also invite the staff of other Chartered Accountants and clients to attend the same. However, undue prominence should not be given to the name of the Chartered Accountant in any booklet or document issued in connection therewith.

Writing Articles or Letters to the Press: Members writing articles or letters to the Press on subjects connected with the profession may give their names and use the description Chartered Accountants.

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Size of Sign Board: With regard to the size of sign board for his office that a member can put up, it is a matter in which the members should exercise their own discretion and good taste while keeping in mind the appropriate visibility and illumination (limited to the sake of visibility). However, use of glow signs or lights on large-sized boards as is used by traders or shop-keepers is not permissible. A member can have a name board at the place of his residence with the designation of a Chartered Accountant, provided it is a name plate or name board of an individual member and not of the firm.

Public Announcements with details of Directors: The Council's attention has been drawn to the fact that more and more Companies are appointing Chartered Accountants as Directors on their Boards. The prospectus or public announcements issued by these Companies often publish descriptions about the Chartered Accountant's expertise, specialisation and knowledge in any particular field or add appellations or adjectives to their names. Attention of the members in this context is invited to the provisions of Clause (6) and (7) of Part I of the First Schedule to the Chartered Accountants Act.

In order that the inclusion of the name of a member of the Institute in the prospectus or public announcements or other public communications issued by the Companies in which the member is a director does not contravene the above noted provisions, it is necessary that the members should take necessary steps to ensure that such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the member. While it may be difficult to lay down a rigid rule in this respect, the members must use their good judgement, depending upon the facts and circumstances of each case to ensure that the above noted provisions are complied with both in letter and spirit.

It is advisable for a member that as soon as he is appointed as a director on the Board of a Company, he should specifically invite the attention of the management of the Company to the aforesaid provisions and should request that before any such prospectus or public announcements or public communication mentioning the name of the member concerned, is issued, the material pertaining to the member concerned should, as far as practicable be got approved by him. The use of the expression 'Chartered Accountant' is permissible. However, the member must ensure that descriptions about his expertise, specialisation and knowledge in any particular field or other appellations or adjectives are not published with his name. Particulars about directorships held by the member in other Companies can, however, be given, but the name of the firm of Chartered Accountants in which the member is a partner, should not be given.

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Network Firms and Networking Guidelines: ***The Council has permitted Network amongst the Firms registered with the Institute. A member of the Network may advertise to the extent permitted by the Advertisement Guidelines issued by Institute.***

Note:
Students are required to refer Para 9 of this Chapter for Guidelines for Networking discussed in Chapter XV of Council General Guidelines 2008.
Advertisement Guidelines issued by Institute are being given in details in the Chapter

Use of Logo: For use of logos by Members on letter heads, visiting cards etc. the Council had decided that the logos unconnected with the first letter of the name of the firm or its partners or proprietors would not be permitted for use by members in practice/firms of Chartered Accountants on their letter heads, visiting cards etc. as the same would have amounted to advertisement or smacking of publicity. Subsequent to above, the Institute came across cases of registration of firm name in circumvention of the provisions contained in the Regulation 190 of the Chartered Accountants Regulations, 1988. The members/firms by themselves or through engineered name had been seeking to obtain firm name approval based on the name of the partner/s selected in the manner that logo of the firm would be identical to the firm name which would have not otherwise been permissible as firm name under Regulation 190.

In order to ensure compliance with the Regulations, the Council decided that the use of logo/monogram of any kind/form/ style/design/colour etc. whatsoever on any display material or media e.g. paper stationery, documents, visiting cards, magnetic devices, internet, sign board, by the members in practice and/or the firm of Chartered Accountants, be prohibited. Use/printing of member/firm name in any other manner tantamounting to logo/monogram was also prohibited.

Common CA Logo: To promote the brand of CA profession and responding to the long felt need to have a symbol of CA Profession in India, ICAI came up with a unique logo which could be used by all members, whether in practice or not. Encapsulating the current beliefs, attitudes and values of the profession, the CA Logo seeks to enhance the identity of the members. ***Guidelines issued in 2023 for using the new CA India logo for CA members prescribes that the logo consists of the letters 'CA' in blue colour with a tri colour tick mark (upside down) with white background. The blue colour not only stands out on any background but also denotes creativity, innovativeness, knowledge, integrity, trust, truth, stability, and depth. The upside-down tick mark, typically used by Chartered Accountants, has been included to symbolise the wisdom and value of the professional. 'India' is also added in the logo, as it epitomizes the Institute's connection to India First approach and commitment to the serve the Indian economy in public interest.***.

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[Students are advised to refer Chapter XVI on Logo Guidelines under Para no 9 Council Guidelines.]

Guidelines for elected Members of the Council/ office Bearers of the Regional Council in the context of use of designation etc. and manner of Printing of Letter-heads and visiting cards.

The guidelines/directions laid down by the Council as revised by the Council from time to time for use of designation etc. and manner of printing letter-heads and visiting cards of the President, Vice-President of the Institute, Members of the Council, Chairmen of various non-standing Committees of the Institute; Chairmen, other office bearers and Members of the Regional Councils; Chairmen, other office-bearers and Members of the Managing Committees of the Branches are appearing in **Appendix 'F'** to Code of Ethics publication.

Illustration 11

A practising Chartered Accountant uses a visiting card in which he designates himself, besides as Chartered Accountant, as a Tax Consultant.

Tax Consultant: Section 7 of the Chartered Accountants Act, 1949 read with Clause (7) of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public.

Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council.

Conclusion: Thus, it is improper to use designation "Tax Consultant" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council.

Illustration 12

B, a Chartered Accountant in practice is a partner in 3 firms. While printing his personal letter heads, B gave the names of all the firms in which he is a partner.

Advertisement of Professional Attainments: Clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member

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would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm on letterheads. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner.

Conclusion: Thus, B is not guilty of any misconduct under the Chartered Accountants Act, 1949.

Illustration 13

The offer document of a listed company in which Mr. D, a practising Chartered Accountant is a director mentions the name of Mr. D as a director along with his various professional attainments and spheres of specialisation.

Advertisement of Professional Attainments: The Council of the ICAI has in a communication to members stated that if a public company, in which a chartered accountant in practice is a director, issues a prospectus or gives any announcement that gives descriptions about the Chartered Accountant's expertise, specialisation and knowledge in any particular field, it shall constitute a misconduct under Clauses (6) and (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949. The Council has further stated that in such cases the member concerned has to take necessary steps to ensure that such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the members.

Conclusion: *Thus, in the instant case, Mr. D would be held to be guilty of professional mis-conduct and liable for disciplinary action.*

Illustration 14

A Chartered Accountant in practice, empanelled as an Insolvency Professional (IP) has mentioned the same on his visiting cards, letter heads and other communications also. A person residing in his neighbourhood, has filed a complaint for professional misconduct against the said member for such mention of IP.

Using Designation of Insolvency Professional: As per Clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than 'Chartered Accountant" on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

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Here, a Chartered Accountant empaneled as IP (Insolvency Professional) can mention "Insolvency Professional" on his visiting cards, letter heads and other communication, as this is a title recognised by the Central Government in terms of Clause 7 of Part 1 of First Schedule to the Chartered Accountants Act, 1949.

Conclusion: Thus, complaint of neighbor is not enforceable/ valid.

Clause (8) accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing.

It must be pointed out that professional courtesy alone is not the major reason for requiring a member to communicate with the existing accountant who is a member of the Institute or a certified auditor. The underlying objective is that the member may have an opportunity to know the reasons for the change in order to be able to safeguard his own interest, the legitimate interest of the public and the independence of the existing accountant. It is not intended, in any way, to prevent or obstruct the change. When making the inquiry from the retiring auditor, the one proposed to be appointed or already appointed should primarily find out whether there are any professional or other reasons why he should not accept the appointment.

It is important to remember that every client has an inherent right to choose his accountant also that he may, subject to compliance, with the statutory requirements in the case of limited companies, make a change whenever he chooses, whether or not the reasons which had impelled him to do so are good and valid. The change normally occurs where there has been a change of venue of business and a local accountant is preferred or where the partner who has been dealing with the client's affairs retires or dies; or where temperaments clash or the client has some good reasons to feel dissatisfied. In such cases, the retiring auditor should always accept the situation with good grace.

The existence of a dispute as regards the fees may be root cause of an auditor being changed. This would not constitute valid professional reasons on account of which an audit should not be accepted by the member to whom it is offered. However, in the case of an undisputed audit fees for carrying out the statutory audit under the Companies Act, 2013 or various other statutes having not been paid, the incoming auditor should not accept the appointment unless such fees are paid. In respect of other dues, the incoming auditor should in appropriate circumstances use his influence in favour of his predecessor to have the dispute as regards the fees settled. The professional reasons for not accepting an audit would be:

(a) Non-compliance of the provisions of Sections 139 and 140 of the Companies Act, 2013 as mentioned in Clause (9) of the Part - I of First Schedule to The Chartered Accountants Act, 1949; and

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(b) Non-payment of undisputed Audit Fees by auditees other than in case of Sick Units for carrying out the Statutory Audit under the Companies Act, 2013 or various other statutes; and

(c) Issuance of a qualified report.

In the first two cases, an auditor who accepts the audit would be guilty of professional misconduct. In this connection, attention of members is invited to the Council General Guidelines, 2008 appearing in Chapter-4. In the said Guidelines, Council has explained that the *provision for audit fee in accounts signed by both the auditee and the auditor along with other expenses, if any, incurred by the auditor in connection with the audit*, *shall* be considered as *"undisputed audit fee"* and *"sick unit"* shall mean *a unit registered for not less than five years, which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.*

In the last case, however, he may accept the audit if he is satisfied that the attitude of the retiring auditor was not proper and justified. If, on the other hand, he feels that the retiring auditor had qualified the report for good and valid reasons, he should refuse to accept the audit. There is no rule, written or unwritten, which would prevent an auditor from accepting the appointment offered to him in these circumstances. However, before accepting the audit, he should ascertain the full facts of the case. For nothing will bring the profession to disrepute so much as the knowledge amongst the public that if an auditor is found to be "inconvenient" by the client, he could readily be replaced by another who would not displease the client and this point cannot be too over-emphasised.

Where the Previous Auditor is not available for accepting payment of undisputed audit fees, and it is not otherwise possible to transfer the payment to him electronically, the Incoming Auditor may advise the client to purchase Demand Draft of the amount equivalent to undisputed Audit Fees of retiring auditor, and may accept the Audit assignment after verifying the same. It will be the duty of the Incoming auditor to ensure the payment of undisputed Audit Fees of the retiring auditor at the earliest possibility.

What should be the correct procedure to adopt when a prospective client tells you that he wants to change his auditor and wants you to take up his work? There being two persons involved, the Company and the old auditor, the former should be asked whether the retiring auditor had been informed of the intention to change. If the answer is in the affirmative, then a communication should be addressed to the retiring auditor. If, however, it is learnt that the old auditor has not been informed, and the client is not willing to make the first move, it would be necessary to ask him the reason for the proposed change. If there is no valid reason for a change, it would be healthy practice not to accept the audit. If he decides to accept the audit he should address a communication to the retiring auditor.

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As stated earlier, the object of the incoming auditor, in communicating with the retiring auditor is to ascertain from him whether there are any circumstances which warrant him not to accept the appointment.



5. For example, whether the previous auditor has been changed on account of having qualified his report or he had expressed a wish not to continue on account of something inherently wrong with the administration of the business. The retiring auditor may even give out information regarding the condition of the accounts of the client or the reason that impelled him to qualify his report. In all these cases it would be essential for the incoming auditor to carefully consider the facts before deciding whether or not he should accept the audit, and should he do so, he must also take into account the information while discharging his duties and responsibilities.

Sometimes, the retiring auditor fails without justifiable cause except a feeling of hurt because of the change, to respond to the communication of the incoming auditor. So that it may not create a deadlock, the auditor appointed can act, after waiting for a reasonable time for a reply.

The Council has taken the view that a mere posting of a letter "under certificate of posting" is not sufficient to establish communication with the retiring auditor unless there is some evidence to show that the letter has in fact reached the person communicated with. A Chartered Accountant who relies solely upon a letter posted "under certificate of posting" therefore does so at his own risk.

The view taken by the Council has been confirmed in a decision by the Rajasthan High Court in J.S. Bhati v.s. The Council of the Institute of Chartered Accountants of India and another. The following observations of the Court are relevant in this context:

"Mere obtaining a certificate of posting in my opinion does not fulfil the requirements of Clause (8) of Schedule I as the presumption under Section 114 of the Evidence Act that the letter in due course reached the addressee cannot replace that positive degree of proof of the delivery of the letter to the addressee which the letters of the law in that case required. The expression 'in 'communication with' when read in the light of the instructions contained in the booklet 'Code of Conduct' (now Code of Ethics) cannot be interpreted in any other manner but to mean that there should be positive evidence of the fact that the communication addressed to the outgoing auditor by the incoming auditor reached his hands. Certificate of posting of a letter cannot, in the circumstances, be taken as a positive proof of its delivery to the addressee".

Members should therefore communicate with a retiring auditor in such a manner as to retain in their hands **positive evidence of the delivery** of the communication to the addressee. In the opinion of the Council, the following would in the normal course provide such evidence:-

(a) Communication by a letter sent through "Registered Acknowledgement due", or

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(b) By hand against a written acknowledgement, or

(c) Acknowledgement of the communication from retiring auditor's vide email address registered with the Institute or his last known official email address, or

(d) Unique Identification Number (UDIN) generated on UDIN portal (subject to separate guidelines to be issued by the Council in this regard)

Premises found Locked: The communication received back by the Incoming Auditor with **"Office found Locked"** written on the Acknowledgement Due shall be deemed as having been delivered to the retiring auditor.

Firm not found at the given Registered address : If the Communication sent by the Incoming auditor is received back with remarks "No such office exists at this address", and the address of communication is the same as registered with the Institute on the date of dispatch, the letter will be deemed to be delivered, unless the retiring auditor proves that it was not really served and that he was not responsible for such non-service.

As a matter of professional courtesy and professional obligation it is necessary for the new auditor appointed to act jointly with the earlier auditor and to communicate with such earlier auditor.

Special Audit under Income Tax Act, 1961: It would be a healthy practice if a Tax Auditor appointed for conducting special audit under the Income Tax Act,1961 communicates with the member who has conducted the Statutory Audit.

The Council has also laid down the detailed guidelines on the subject as under:-

Communication required for all kinds of audit: The requirement for communicating with the previous auditor being a Chartered Accountant in practice would apply to all types of Audit viz., Statutory Audit, Tax Audit, GST Audit, Internal Audit, Concurrent Audit or any other kind of audit.

Communication in case of Assignments done by other professionals: A Communication is mandatorily required for all types of Audit/Report where the previous auditor is a Chartered Accountant. In case of assignments done by other professionals not being Chartered Accountants, it would also be a healthy practice to communicate.

Lack of time in acceptance of Government Audits: Although the mandatory requirement of communication with previous auditor being Chartered Accountant applies, in uniform manner, to audits of both government and Non-Government entities, yet in the case of audit of government Companies/ banks or their branches, if the appointment is made well in time to enable the obligation cast under this clause to be fulfilled, such obligation must be complied with before accepting the audit. However, in case the time schedule given for the assignment is such that there is no time to

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wait for the reply from the outgoing auditor, the incoming auditor may give a conditional acceptance of the appointment and commence the work which needs to be attended to immediately after he has sent the communication to the previous auditor in accordance with this clause. In his acceptance letter, he should make clear to the client that his acceptance of appointment is subject to professional objections, if any, from the previous auditors and that he will decide about his final acceptance after taking into account the information received from the previous auditor.

Illustration 15

Mr. X, a Chartered Accountant accepted his appointment as tax auditor of a firm under Section 44AB, of the Income-tax Act,1961 and commenced the tax audit within two days of his appointment since the client was in a hurry to file Return of Income before the due date. After commencing the audit, Mr. X realised his mistake of accepting this tax audit without sending any communication to the previous tax auditor. In order to rectify his mistake, before signing the tax audit report, he sent a registered post to the previous auditor and obtained the postal acknowledgement. Will Mr. X be held guilty under the Chartered Accountants Act?

Communication with the Previous Auditor: As per Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949, Mr. X will be held guilty since he has accepted the tax audit, without first communicating with the previous auditor in writing. The object of the incoming auditor communicating in writing with the retiring auditor is to ascertain whether there are any circumstances which warrant him not to accept the appointment, for example, whether the previous auditor has been changed on account of having qualified the report or he had expressed a wish not to continue on account of something inherently wrong with the administration of the business. The retiring auditor may even give out information regarding the condition of the accounts of the client or the reason that impelled him to qualify his report. Under all circumstances, it would be essential for the incoming auditor to carefully consider the facts before deciding whether or not he should accept the audit. As a matter of professional courtesy and professional obligation it is necessary for the new auditor appointed to communicate with such earlier auditor.

Conclusion: Therefore, Mr. X will be held guilty of professional misconduct.

Illustration 16

W, a Chartered Accountant had sent letters under certificate of posting to the previous auditor informing him his appointment as an auditor before the commencement of audit by him.

Communication with the Previous Auditor: Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 requires communication by the incoming auditor with the

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previous auditor before accepting a position by him. The Council of the Institute has taken the view that a mere posting of a letter "under certificate of posting" is not sufficient to establish communication with the retiring auditor unless there is some evidence to show that the letter has in fact reached the person communicated with. A Chartered Accountant who relies solely upon a letter posted "under certificate of posting" therefore does so at his own risk. Since the letters were sent by "W" to the previous auditor informing him of his appointment as an auditor before the commencement of audit by him under Certificate of Posting is not sufficient to prove communication with the retiring auditor. In the opinion of the Council, communication by a letter sent "Registered Acknowledgement Due" or by hand against a written acknowledgement would in the normal course provide positive evidence.

Conclusion: Hence "W" was guilty of professional misconduct under Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949

Clause (9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 (1 of 1956), or sections 139 to 141 of the Companies Act, 2013 or any other law pertaining to appointment of auditors for the time being in force, in respect of such appointment have been duly complied with;**

The Companies Act, 2013 provides for the requirements which an auditor appointed in respect of a Company should satisfy himself about, before he accepts the appointment. The relevant provisions are contained in Section 139 and 140 of the Companies Act, 2013 Act (erstwhile Section 225 of the Companies Act, 1956) and the Council has notified that the provisions to be complied with under Clause (9) are those contained in Sections 139 and 140 of the Act. Section 139 contains several provisions in the matter of appointment of auditors in different circumstances and situations whereas Section 140 lays down the procedure which must be followed whenever a Company desires to change its auditors. In order that the validity of the appointment of an auditor is not challenged or objected to by shareholders or the retiring auditors at a later date, it has been made obligatory on the Incoming Auditor to ascertain from the Company that the appropriate procedure in the matter of appointment has been faithfully followed.

The following guidelines have been issued by the Council for this purpose:-

Clause (9) of Part I of the First Schedule to Chartered Accountants Act, 1949 provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a Company without first ascertaining from it whether the requirements of Sections 139 and 140 of the Companies Act, 2013, in respect of such appointment have been duly complied with. Under this clause it is obligatory on the incoming auditor to ascertain from the Company that the appropriate procedure in the matter of his appointment has been duly complied with so that no shareholder or retiring auditor may, at a later date, challenge the validity of such appointment.

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The steps to be taken by an Auditor of a Company who is appointed in the following circumstances are indicated in the paragraphs below:

(a) When the auditor appointed is the First Auditor of the Company.

(b) When the auditor is appointed in place of an existing auditor who has resigned or has been removed or has ceased to hold office for any other reason.

(c) When the auditor or auditors appointed by the Company were holding this office jointly with others and one or more of such joint auditors are not reappointed.

(d) When one or more of the auditors appointed by the Company was/were not holding this office earlier.

Note : Students are advised to refer Intermediate level Paper 2 Corporate and Other Law for more details regarding Section 139 and 140, Section 139 of the Companies Act, 2013 laid down the procedure to be followed by a Company for appointment of an auditor and Section 140 of the Companies Act, 2013 lays down the procedure for appointment of auditor other than the retiring auditor and for removal of existing auditor.

The procedure to be followed by the Company is given below:-

- If a member of the Company wants that the retiring auditor should not be reappointed or that an auditor other than the retiring auditor should be appointed, he has to give a special notice u/s 140(4) of the Companies Act, 2013 to the Company for a resolution at the Annual General Meeting for this purpose.
- Such special notice is also required to be given if a member of the Company wants to remove the auditor before the expiry of his term of office. The special notice should be given before the date of the General Meeting when the question of appointment or reappointment of the auditor is to be considered.
- On receipt of the special notice of such a resolution, the Company has to send a copy of the same to the retiring auditor forthwith, as required u/s 140(4) of the Companies Act, 2013.
- The Company is also required to send the special notice to the members of the Company at least seven days before the Meeting as per the provisions of Section 115 read with Section 20 of the Companies Act, 2013. According to these provisions, a document may be served on a company or an officer thereof by sending it to the company or the officer at the registered office of the company by registered post or by speed post or by courier service or by leaving it at its registered office or by means of such electronic or other mode as may be prescribed.

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- After receipt of the above notice, the retiring auditor can submit his representation to the members of the Company. Such representation, on receipt by the Company, is required to be sent to its members as required under Section 140(4) of the Companies Act.
- The representation received from the retiring auditor will have to be considered at the General Meeting of the Company before the resolution proposed by the concerned member is passed. The resolution proposed by the concerned member can be passed only in accordance with the provisions of Section 114 of the Companies Act, 2013.
- Under Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949, the incoming auditor has to ascertain whether the Company has complied with the provisions of the above sections. The word "ascertain" means “to find out for certain”. This would mean that the incoming auditor should find out for certain as to whether the Company has complied with the provisions of Sections 139 and, 140 of the Companies Act, 2013. In this respect, it would not be sufficient for the incoming auditor to accept a certificate from the management of the Company that the provisions of the above sections have been complied with. It is necessary for the incoming auditor to verify the relevant records of the Company and ascertain as to whether the Company has, in fact, complied with the provisions of the above sections. If the Company is not willing to allow the incoming auditor to verify the relevant records in order to enable him to ascertain as to whether the provisions of the above sections have been complied with, the incoming auditor should not accept the audit assignment.

It is suggested that the incoming auditor should verify the following records of the Company:-

If the appointment of the auditor is being made for the first time after incorporation of the Company, the auditor should verify as to whether the Board of Directors have passed the resolution for his appointment within thirty days of the date of registration of the Company.

If the Board of Directors have not appointed the first auditor but the appointment is being made by a general meeting of the Company, the auditor should verify as to whether a proper notice convening the general meeting has been issued by the Company and whether the resolution has been validly passed at the general meeting of the Company.

If the appointment is being made to fill a casual vacancy, the incoming auditor should verify as to whether the Board of Directors have powers to fill the casual vacancy and whether the Board of Directors have passed the resolution filling the casual vacancy.

If the vacancy has arisen due to resignation of the auditor, the incoming auditor should see as to whether a proper resolution filling the vacancy has been passed at the General Meeting of the Company.

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If the vacancy has arisen as a result of removal of the auditor before the expiry of his term of office, the incoming auditor should see that special resolution has been passed at the General Meeting of the Company and that the previous approval of the Central Government has been obtained by the Company.

Where the auditor other than the retiring auditor is proposed to be appointed, the incoming auditor should ascertain whether the provisions of Sections 139 and 140 have been complied with. These provisions equally apply where an auditor who was jointly holding office with another auditor or auditors and any one or more of such joint auditors has not been reappointed.

For the purpose of ascertaining whether the Company has complied with the provisions of Section 140 of the Companies Act the incoming auditor should verify the records of the Company in respect of the following matters:-

a. Whether a member of the Company has given special notice of the resolution as required under Section 140 (4) of the Companies Act, 2013. The notice shall be sent by members to the company not earlier than three months but at least fourteen days before the date of the meeting at which the resolution is to be moved, exclusive of the day on which the notice is given and the day of the meeting. A true copy of this notice should be obtained by the incoming auditor.

b. Whether this special notice has been sent to all the members, of the Company as required under Section 115 of the Companies Act, 2013 at least 7 days before the date of the General Meeting.

c. Whether this special notice has been sent to the retiring auditor forthwith as required under Section 140 (4).

d. Whether the representation received from the retiring auditor has been sent to the members of the Company as required under Section 140 (4).

e. Whether the representation received from the retiring auditor has been considered at the general meeting and the resolution proposed by the special notice has been properly passed at the general meeting.

As regards the mode of sending the notice of the resolution to the members of the Company as provided in Sections 139 and 140 and section 20 to be followed for service of documents, which is as under:-

(A) A document may be served on a company or an officer thereof by sending it to the company or the officer at the registered office of the company by registered post or by speed post or

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by courier service or by leaving it at its registered office or by means of such electronic or other mode as may be prescribed.

(B) As regards the mode of sending the notice of the resolution to the retiring auditor as provided in Sections 224 & 225 of Companies Act, 1956 (equivalent Sections being Section 139 & 140 of Companies Act, 2013), attention is invited to the Department of Company Affairs circular dated 17.10.1981 issued to all Chambers of Commerce, which is reproduced below:-

"I am directed to say that it has been reported by the Institute of Chartered Accountants of India that difficulties are being experienced by retiring Auditors in the operation of the provisions of Section 225 of the Companies Act, 1956 whenever any appointment of a new auditor takes place. Such difficulties arise because of the fact that the copy of the special notice required to be served u/s 225(2) of the Act on the retiring auditors are not effectively served and proof of such service is not available. To obviate such difficulties; therefore, it is advisable that the copy of the special notice u/s 225(2) of the Act should be sent to the retiring auditors by Registered A/D post."

(C) Accordingly, it is necessary for the incoming auditor to satisfy himself that the notice provided for in Sections 139 & 140 of the Companies Act, 2013 has been effectively served on the outgoing auditor (e.g. by seeing that the notice has been duly served through hand delivery or by Regd. Post with A.D.). Production of a certificate of posting by the Company would not be adequate for the purpose of the incoming auditor satisfying himself about compliance with Sections 139/140. Acknowledgement received from the outgoing auditor would be one of the forms in which such satisfaction can be obtained.

A copy of the relevant minutes of the general meeting where the above resolution is passed duly verified by the Chairman of the meeting should also be obtained by the incoming auditor for his records.

Sometimes the annual general meeting is adjourned without conducting any business or after conducting business in respect of some of the items on the agenda. The items in respect of which the business is conducted may or may not include the item relating to appointment of auditors. Under Section 139(1) the retiring auditor holds office till the conclusion of every sixth annual general meeting. Therefore, when the annual general meeting is adjourned in the circumstances stated above, the retiring auditor will continue to hold the office of auditor till the adjourned meeting is held and the business listed in the agenda of the meeting is concluded. In case a new auditor is appointed at the original meeting (which is adjourned) such auditor can assume office only after the conclusion of such adjourned meeting.

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If any annual general meeting is adjourned without appointing an auditor, no special notice for removal or replacement of the retiring auditor received after the adjournment can be taken note of and acted upon by the Company, since in terms of Section 115 of the Companies Act, special notice should be given to the Company at least fourteen clear days before the meeting in which the subject matter of the notice is to be considered. The meeting contemplated in Section 115 undoubtedly is the original meeting. Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company mentioned in Section 139.

If the incoming auditor is satisfied that the Company has complied with the provisions of Sections 139 and 140 of the Companies Act, he should first communicate with the outgoing auditor in writing as provided in Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 before accepting the audit assignment.

Unjustified removal of auditors: In order to examine various ethical issues and safeguard the independence of the Auditors, the Council has set up a Ethical Standards Board (ESB). This Board examines various issues concerning professional ethics governing the members of the Institute which are either raised by the members or are taken up based on their importance. The recommendations of the Board are forwarded to the Council for its consideration. This Board is also charged with the responsibility of looking into the cases of removal and resignation of auditors and making an appropriate report to the Council.

The following guidelines have been issued for the Board for looking into the cases of Removal of Auditors:
A. Where an auditor resigns his appointment as an auditor of a Company or does not offer himself for reappointment as auditor of such Company, he shall send a communication, in writing, to the Board of Directors of the Company giving reasons therefor, if he considers that there are professional reasons connected with his resignation or not offering himself for re-appointment which, in his opinion, should be brought to the notice of the Board of Directors, and shall send a copy of such communication to the Institute. It shall be obligatory on the incoming auditor, before accepting appointment, to obtain a copy of such communication from the Board of Directors and consider the same before accepting the appointment.
B. Where an auditor, though willing for re-appointment has not been reappointed, he shall file with the Institute a copy of the statement which he may have sent to the management of the Company for circulation among the shareholders. It shall be obligatory on the incoming auditor before accepting the appointment, to obtain a copy of such a communication from the Company and consider it, before accepting the appointment.

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C. The Ethical Standards Board, on a review of the communications referred to in paras (A) and (B), may call for such further information as it may require from the incoming auditor, the outgoing auditor and the Company and make a report to the Council in cases where it considers necessary.

D. The above procedure is also followed in the case of removal of auditors by the government and other statutory authorities.

[Note: Students are advised to refer Appendix 'G' For the Mission Statement, Terms of Reference and Procedure to be followed by the Board for dealing with the cases of Unjustified Removal of Auditors.]

Illustration 17

CA Raja was appointed as the Auditor of Castle Ltd. for the year 2023-24. Since he declined to accept the appointment, the Board of Directors appointed CA Rani as the auditor in the place of CA Raja, which was also accepted by CA Rani.

Appointment of Auditor by Board: Board can appoint the auditor in the case of casual vacancy under section 139(8) of the Companies Act, 2013. The non-acceptance of appointment by CA Raja does not constitute a casual vacancy to be filled by the Board. In this case, it will be deemed that no auditor was appointed in the AGM.

Further, as per Section 139(10) of the Companies Act, 2013 when at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company. The appointment of the auditor by the Board is defective in law.

Clause (9) of Part I of First Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant is deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of section 225 of the Companies Act, 1956 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been fully complied with.

Conclusion: Hence, CA Rani is guilty of professional misconduct since she accepted the appointment without verification of statutory requirements.

Illustration 18

Mr. X is a Chartered Accountant accepted the appointment as Statutory Auditor of the Company ABC Ltd. without communicating with the previous auditor before accepting the audit. He also

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failed to ascertain the compliance of requirement of Section 139 and 140 of the Companies Act, 2013 in respect of the appointments have been duly complied with.

Communication by incoming auditor with previous auditor: Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 requires communication by the incoming auditor with the previous auditor before accepting a position by him.

Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 (now Section 139 and 140 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Under this clause it is obligatory on the incoming auditor to communicate with previous auditor and ascertain from the Company that the appropriate procedure in the matter of his appointment has been duly complied with so that no shareholder or retiring auditor may, at a later date, challenge the validity of such appointment.

In this case Mr. X accepted the appointment as Statutory Auditor of the Company ABC Ltd. without communicating with the previous auditor. Further, he accepted the appointment without first ascertaining whether the requirement of Section 139 and 140 of the Companies Act, 2013 in respect of the appointments have been duly complied with.

Conclusion: Therefore, Mr. X is liable for misconduct under clause 8 and Clause 9 since he accepted the appointment without communicating with previous auditor as well as for not verifying the compliance of statutory requirements.

Clause (10) charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

What distinguishes a profession from a business is that professional services are not rendered with the sole purpose of a profit motive. Personal gain is one but not the main or the only objective. Professional opinion, therefore frowns upon methods where payment is made to depend on the basis of results. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the advantage of his service or may adopt means that are not ethical. It will have the effect of undermining his integrity and impairing his independence. Therefore, members are prohibited from charging or accepting any remuneration

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based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings.

Professional services should not be offered or rendered under an arrangement whereby no fee will be charged unless a specified finding or result is obtained or where the fee is otherwise contingent upon the findings or results of such services. However, fees should not be regarded as being contingent if fixed by a court or other public authority.

The Council of the Institute has however framed Regulation 192 which exempts members from the operation of this clause in certain professional services. The said Regulation 192 is reproduced -

192. Restriction on fees - No Chartered Accountant in practice shall charge or offer to charge, accept or offer to accept, in respect of any professional work, fees which are based on a percentage of profits, or which are contingent upon the findings or results of such work, provided that:

(a) "In the case of a receiver or a liquidator, the fees may be based on a percentage of the realization or disbursement of the assets;

(b) In the case of an auditor of a co-operative society, the fees may be based on a percentage of the paid up capital or the working capital or the gross or net income or profits;

(c) In the case of a valuer for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of property valued;

(d) in the case of certain management consultancy services as may be decided by the resolution of the Council from time to time, the fees may be based on percentage basis which may be contingent upon the findings, or results of such work;

(e) in the case of certain fund raising services, the fees may be based on a percentage of the fund raised;

(f) in the case of debt recovery services, the fees may be based on a percentage of the debt recovered;

(g) in the case of services related to cost optimisation, the fees may be based on a percentage of the benefit derived; and

(h) any other service or audit as may be decided by the Council. [**Following activities have been decided by the Council under "h" above :-(i) Acting as Insolvency Professional;(ii) Non-Assurance Services to Non-Audit Clients]**

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Illustration 19

Mr. P a practicing chartered accountant acting as liquidator of AB & Co. charged his professional fees on percentage of the realization of assets.

Restriction on fees based on a Percentage: According to Clause (10) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

However, CA Regulation allow the Chartered Accountant in practice to charge the fees in respect of any professional work which are based on a percentage of profits, or which are contingent upon the findings or results of such work, in the case of a receiver or a liquidator, and the fees may be based on a percentage of the realization or disbursement of the assets.

In the given case, Mr. P, a practicing Chartered Accountant, has acted as liquidator of AB & Co. and charged his professional fees on percentage of the realisation of assets.

Conclusion: Therefore, Mr. P shall not be held guilty of professional misconduct as he is allowed to charge fees on percentage of the realisation of assets being a liquidator.

Clause (11) engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company (Not being managing director or a whole time director) unless he or any of his partners is interested in such company as an auditor.

This is a provision introduced to restrain a member in practice from engaging himself in any business or occupation other than that of chartered accountant except when permitted by the Council to be so engaged. The objective is to restrain members from carrying on any other business in conjunction with the profession of accountancy and combining such work with any business, which is not in keeping with the dignity of the profession. Another reason for the introduction of such prohibition is that a chartered accountant, if permitted to enter into all kinds of business, would be able to advertise for his other business and thereby secure an unfair advantage in his professional practice.

The Council, on a very careful consideration of the matter, has formulated Regulation, 190A and 191 which are reproduced below, specifying the activities with which a member in practice can associate himself with or without the permission of the Council.

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190A. Chartered Accountant in practice not to engage in any other business or occupation.

"A chartered accountant in practice not to engage in any other business or occupation other than the profession of accountancy except with the permission granted in accordance with a resolution of the Council".

191. Part-time employment a Chartered Accountant in practice may accept.

"Notwithstanding anything contained in Regulation 190A but subject to the control of the Council, a Chartered Accountant in practice may act as a liquidator, trustee, executor, administrator, arbitrator, receiver, adviser or representative for costing, financial or taxation matter, or may take up an appointment that may be made by the Central Government or a State Government or a court of law or any other legal authority or may act as a Secretary in his professional capacity, provided his employment is not on a salary-cum-full-time basis".

Appendix 9 C.A. Regulations, 1988

The General and specific Resolutions passed by the Council under the power vested in it under Regulation 190A as included in Appendix 9 of C.A. Regulations, 1988 are also reproduced below for information.

General Resolution

Permission granted generally - Members of the Institute in practice be generally permitted to engage in the following categories of occupations, for which no specific permission from the Council would be necessary in individual cases:

(1) Employment under Chartered Accountants in practice or firms of such chartered accountants.

(2) Private tutorship.

(3) Authorship of books and articles.

(4) Holding of Life Insurance Agency License for the limited purpose of getting renewal commission.

(5) Attending classes and appearing for any examination.

(6) Holding of public elective offices such as M.P., M.L.A. and M.L.C.

(7) Honorary office leadership of charitable-educational or other non-commercial organisations.

(8) Acting as Notary Public, Justice of the Peace, Special Executive Magistrate and the like.

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(9) Part-time tutorship under the coaching organisation of the Institute.

(10) Valuation of papers, acting as paper-setter, head-examiner or a moderator, for any examination.

(11) Editorship of professional journals.

(12) Acting as Surveyor and Loss Assessor under the Insurance Act, 1938 provided they are otherwise eligible.

(13) Acting as recovery consultant in the banking sector

(14) Owning agricultural land and carrying out agricultural activity (w.e.f. August 9th, 2008).

Specific Resolution - Members of the Institute in practice may engage in the following categories of business or occupations, after obtaining the specific and prior approval of the Council in each case:

(1) Full-time or part-time employment in business concerns provided that the member and/or his relatives do not hold "substantial interest" in such concerns.

(2) Full-time or part-time employment in non-business concern.

(3) Office of managing director or a whole-time director of a body corporate within the meaning of the Companies Act, 1956 (now Companies Act, 2013) provided that the member and/or any of his relatives do not hold substantial interest in such concern.

(4) Interest in family business concerns (including such interest devolving on the members as a result of inheritance / succession / partition of the family business) or concerns in which interest has been acquired as a result of relationships and in the management of which no active part is taken.

(5) Interest in an educational institution.

(6) Part-time or full-time lectureship for courses other than those relating to the Institute's examinations conducted under the auspices of the Institute or the Regional councils or their branches.

(7) Part-time or full-time tutorship under any educational institution other than the coaching organization of the Institute.

(8) Editorship of journals other than professional journals.

(9) Any other business or occupation for which the Executive Committee considers that permission may be granted.

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However, it is open to the Council to refuse permission in individual cases though covered under any of the above categories. For the purpose of the above resolution:

(i) the expression "relative", in relation to a member, means the husband, wife, brother or sister or any lineal ascendant or descendant of that member;

(ii) a member shall be deemed to have a "substantial interest" in a concern -

(i) in a case where the concern is a Company, if its shares (not being shares entitled to a fixed rate of dividend whether with or without a further right to participate in profits) carrying not less than twenty per cent of voting power at any time, during the relevant years are owned beneficially by such member or by any one or more of the following persons or partly by such member and partly by one or more of the following persons:

(a) One or more relatives of the member;

(b) Any concerns in which any of the persons referred to above has a substantial interest;

(ii) in the case of any other concern, if such member is entitled or the other persons referred to above or such member and one or more of the other persons referred to above are entitled in the aggregate, at any time during the relevant years to not less than twenty percent of the profits of such concern.

Attention of the members is also invited to para 3 of the above Resolution relating to the holding of office of a managing director or a whole-time director in a company. In such cases, a member can accept the office of a managing director or a whole- time director only after obtaining, the specific and prior approval of the Council. Attention of the members is also invited to the provisions of Section 2(26) of the Companies Act, 1956 (now Section 2(54) of the Companies Act, 2013) under which even where a person is not designated as a managing director or a whole-time director, he can be deemed to be a managing director or a whole-time director if he is entrusted with the whole or substantially the whole of the management of the affairs of the company. It may be pointed out that a member cannot accept and hold the office of a managing director or a whole-time director in a company if the member and/or his partners and relatives hold substantial interest in such a company.

The Council has considered the question of permitting members in practice to become a Director, Managing Director, full time/Executive Director etc. and related issues and the following decisions have been taken.

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As regards the question of permitting member in practice to be a Director, Promoter/Promoter-Director, Subscriber to the Memorandum and Articles of Association of any company including a board managed company, it was decided that -

(a) Director of a Company

(i) The expression "Director Simplicitor" means an ordinary / simple Director who is not a Managing Director or Whole time Director and is required only in the Board Meetings of the company and not paid any remuneration except for attending such meetings.

(ii) A member in practice is permitted generally to be a Director Simplicitor in any Company including a board-managed Company and as such he is not required to obtain any specific permission of the Council in this behalf unless he or any of his partners is interested in such Company as an auditor, irrespective of whether he and/or his relatives hold substantial interest in that Company.

A question arises, whether the auditor of a Subsidiary Company can be a Director of its Holding Company-

The Ethical Standard Board (ESB) noted that, in terms of Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949 a Chartered Accountant in practice cannot engage (unless permitted by the Council so to engage) in any business or occupation other that the profession of Chartered Accountant but he can be a director of a Company (not being a managing director or whole-time director) wherein he or any of his partners is not interested in such company as an auditor. The Board further noted that Public conscience is expected to be ahead of the law. Members, therefore, are expected to interpret the requirement as regards independence much more strictly than what the law requires and should not place themselves in positions which would either compromise or jeopardise their independence. In view of the above, the Board, via a clarification, decided that the auditor of a Subsidiary Company can't be a Director of its Holding Company, as it will affect the independence of an auditor.

(b) Promoter/Promoter Director - There is no bar for a member to be a promoter / signatory to the Memorandum and Articles of Association of any company. There is also no bar for such a promoter / signatory to be a Director Simplicitor of that company irrespective of whether the object of the company include areas which fall within the scope of the profession of Chartered Accountants. Therefore, members are not required to obtain specific permission of the Council in such cases. It must be clarified that under Section 25 of the Chartered Accountants Act, no Company can practise as a Chartered Accountant.

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(c) Member in practice in a HUF doing business - "A member of the Institute can acquire interest in family business in any of the following manner:

(i) as a proprietary firm

(ii) as a partnership firm

(iii) in the name and style of Hindu Undivided Family as its Karta or a member.

It would be necessary for the members to provide evidence that interest in the family business concern devolved on him as a result of inheritance/succession/partition of the family business. It is also necessary for the member to show that he was not actively engaged in carrying on the said business and that the family business concern in question was not created by himself.

To establish his case, the member should furnish a declaration in the prescribed format and the documents evidencing above for consideration to the concerned Decentralized Office."

A member in practice engaged as Karta of a HUF doing family business, will be within the limit prescribed by Council if he makes investments from the funds pertaining to HUF only, provided, he is not actively engaged in the management of the said business.

Students may also note that as per decision taken by appropriate authority in Council, Regulation 190A of the Chartered Accountants Regulations, 1988 provides that a chartered accountant in practice shall not engage in any business or occupation other than the profession of accountancy, except with the permission granted in accordance with a resolution of the Council. The Council has passed a Resolution under Regulation 190A granting general permission (for private tutorship, and part-time tutorship under Coaching organization of the Institute) and specific permission (for part-time or full-time tutorship under any educational institution other than Coaching organization of the Institute). Such general and specific permission granted is subject to the condition that the direct teaching hours devoted to such activities taken together should not exceed 25 hours a week in order to be able to undertake attest functions.

Illustration 20

A chartered accountant holding certificate of practice and having four articled clerks registered under him accepts appointment as a full-time lecturer in a college. Also, he becomes a partner with his brother in a business. Examine his conduct in the light of the Chartered Accountants Act, 1949 and the regulations thereunder.

Specific Permission to be Obtained: Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949 debars a chartered accountant in practice from engaging in any business or occupation other than the profession of chartered accountancy unless permitted by the Council

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of the Institute so to engage. This clause, in effect, has empowered the Council of the Institute to permit chartered accountants in practice to engage in any other business or occupation considered fit and proper. Accordingly, the Council had formulated Regulations 190A and 191 to the Chartered Accountants Regulations, 1988 to provide a basis for considering applications of chartered accountants seeking permission to engage in other business or occupation. A member can accept full- time lecturer-ship in a college only after obtaining the specific and prior approval of the Council as also becoming a partner in a business with his brother would require specific permission.

Conclusion: Thus, the chartered accountant is liable for professional misconduct since he failed to obtain specific and prior approval of the Council in each case.

Illustration 21

Mr. A, a practicing Chartered Accountant, took over as the executive chairman of Software Company on 01-04-2024. On 10-04-2024 he applied to the Council for permission.

Specific Permission to be Obtained: As per Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

In the instant case, Mr. A took over as the executive chairman on 01-04-2024 and applied for permission on 10-04-2024. On the basis of these facts, he was engaged in other occupation between the period 01-04-2024 and 10-04-2024, without the permission of the Council. **Conclusion:** Therefore, Mr. A is guilty of professional misconduct in terms of Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Illustration 22

CA Moksh, a leading income tax practitioner based in Mumbai with exceptional writing skills, also serves as the editor of a non-chartered accountancy-related journal. He devotes approximately 50% of his time to managing the journal's editorial responsibilities of this journal. Is CA Moksh liable for professional misconduct?

Engaging into a Business: As per Clause (11) of Part I of First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

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However, the Council has granted general permission to the members to engage in certain specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In this case, CA Moksh is engaged in the occupation of editorship of journals other than professional journals which is not covered under the general permission.

Conclusion: Hence, specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under Clause (11) of Part I of First Schedule of the Chartered Accountants Act, 1949.

Clause (12) allows a person not being a member of the institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

The above clause prohibits a member from allowing another member who is not his partner to sign any balance sheet, profit and loss account or financial statements on his behalf or on behalf of his firm.

This clause is to be read in conjunction with Section 26 of the Chartered Accountants Act, 1949 which stipulates that 'No person other than a member of the Institute shall sign any document on behalf of a Chartered Accountant in practice or a firm of Chartered Accountants in his or its professional capacity'.

The term 'financial statement' for the purposes of this clause would cover an examination of the accounts or of financial statements given under a statutory enactment or otherwise. A report, however, may cover a wider range of documents but in the context in which it is used in this clause, it would mean only a report arising out of a professional assignment undertaken by him or his firm and submitted by him or his firm to the client(s) or where so required, to an outsider on behalf of himself or on behalf of the firm. The subject matter of report should be the expression of a professional opinion whether, financial or non-financial. The financial statements and the reports referred to in this clause obviously means the financial statements and reports as ultimately finalized and submitted to the outside authorities.

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated in the following instances and such delegation will not attract provisions of this clause:

(i) Issue of audit queries during the course of audit.

(ii) Asking for information or issue of questionnaire.

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(iii) Letter forwarding draft observations/financial statements.

(iv) Initiating and stamping of vouchers and of schedules prepared for the purpose of audit.

(v) Acknowledging and carrying on routine correspondence with clients.

(vi) Issue of memorandum of cash verification and other physical verification or recording the results thereof in the books of the clients.

(vii) Issuing acknowledgements for records produced.

(viii) Raising of bills and issuing acknowledgements for money receipts.

(ix) Attending to routine matters in tax practice, subject to provisions of Section 288 of the Income-tax Act, 1961.

(x) Any other matter incidental to the office administration and routine work involved in practice of accountancy.

It is also clarified that where the authority to sign documents given above is delegated by a chartered accountant or by a firm of chartered accountants the fact that the documents have not been signed by a chartered accountant is not a defence to him or to the firm in an enquiry relating to professional misconduct.

However, the Council has decided that where a Chartered Accountant while signing a report or, a financial statement or any other document is statutorily required to disclose his name, the member should disclose his name while appending his signature on the report or document. Where there is no such statutory requirement, the member may sign in the name of the firm. It may be noted that the revised SA 700 mandates mentioning of Membership No. and Firm Registration No. Members' attention is also drawn towards UDIN Guidelines of the Institute in 2018.

Illustration 23

S, a practicing Chartered Accountant gives power of attorney to an employee Chartered Accountant to sign reports and financial statements on his behalf.

Power of Signing Reports and Financial Statements: Under Clause (12) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

This clause read in conjunction with Section 26 of the Chartered Accountants Act, 1949 stipulates that no person other than the member of the institute shall sign any document on behalf of a Chartered

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Accountant in practice or a firm of Chartered Accountants in his or its professional capacity.

The term 'Financial Statement' for this purpose would cover an examination of the accounts or financial statements given under a statutory enactment or otherwise.

Further, Clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

Conclusion: Accordingly, S is guilty of professional misconduct under Clause (12) of Part I of First Schedule and also under Clause (1) of Part II of Second Schedule for contravening Section 26.

Illustration 24

CA Smart, a practicing Chartered Accountant was on Europe tour between 15-09-24 and 25-09-24. On 18-09-24 a message was received from one of his clients requesting a stock certificate to be produced to the bank on or before 20-09-24. Due to urgency, CA Smart directed his assistant, who is also a Chartered Accountant, to sign and issue the stock certificate after due verification, on his behalf.

Allowing a Member Not Being a Partner to Sign Certificate: As per Clause (12) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct "if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements".

In this case, CA Smart allowed his assistant who is not a partner but a member of the Institute of Chartered Accountants of India to sign stock certificate on his behalf and thereby commits misconduct.

Conclusion: Thus, CA Smart is guilty of professional misconduct under Clause (12) of Part I of First Schedule to the Chartered Accountants Act, 1949.

PART II - Professional misconduct in relation to members of the Institute in service

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person-

Clause (1) pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him.

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A member of the Institute in service is deemed to be guilty of professional misconduct, if he is an employee of any company, firm or person and during that course whatever emoluments he receives, if he either pays or allows to pay or agree to pay any part or share thereof whether directly or indirectly. However, this clause does not restricts such sharing or commitments among relatives, dependents, friends etc., if there is no relationship in procuring or retaining the job and payment is not a consideration for job procurement or retainership.

The clear verdict of this clause is that job must be procured and retained with own professional capabilities and not by any financial deal impairing professional dignity.

Clause (2) accepts or agrees to accept any part of fees, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

This clause restricts to accept or agrees to accept any part of fee, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification. The objective is that when a member is in employment, he must maintain high level of ethics and should not accept any other amount from anyone for which he is not entitled from employer under contractual agreement of service.

[Note: A member in the foregoing circumstances would be guilty of misconduct regardless of the fact that he was in whole-time or part-time employment or that he was holding Certificate of Practice along with his employment.]

Illustration 25

Mr. 'C', a Chartered Accountant holds a certificate of practice while in employment also, recommends a particular lawyer to his employer in respect of a case. The lawyer, out of the professional fee received from employer paid a particular sum as referral fee to Mr. 'C'.

Referral Fee from Lawyer: According to Clause (2) of Part II of First Schedule of the Chartered Accountant Act, 1949, a member of the Institute(other than a member in practice) shall be guilty of professional misconduct, if he being an employee of any company, firm or person accepts or agrees to accept any part of fee, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

In the present case, Mr. C, who beside holding a certificate of practice, is also an employee and by referring a lawyer to the company in respect of a case, he receives a particular sum as referral fee from the lawyer out of his professional fee.

Conclusion: Therefore, Mr. C is guilty of professional misconduct by virtue of Clause (2) of Part II of First schedule.

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PART III - Professional misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he -

Clause (1) not being a fellow of the Institute, acts as a fellow of the Institute.

Clause (2) does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority.

Where a Chartered Accountant had not disclosed to the Institute at any time about his engagement as a proprietor of a non-chartered accountant's firm while holding certificate of practice and had not furnished particulars of his engagement as Director of a company despite various letters of the institute which remained unreplied. Held that he was guilty under Clause (11) of Part I and Clauses (1) and (3) of Part III of the First Schedule.

Where a Chartered Accountant had continued to train an articled clerk though his name was removed from the membership of the Institute and he had failed to send any reply to the Institute asking him to send his explanation as to how he was training as his articled clerk when he was not a member of the Institute. Held that he was guilty under Clause (2) of Part III of the First Schedule.

Illustration 26

Mr. 'G', while applying for a certificate of practice, did not fill in the columns which solicit information about his engagement in other occupation or business, while he was indeed engaged in a business.

Disclosure of Information: As per Clause (2) of Part III of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant, in practice or not, does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority;

In the given case, Mr. "G", a Chartered Accountant while applying for a certificate of practice, did not fill in the columns which solicit information about his engagement in other occupation or business, while he was indeed engaged in a business. Details of engagement in business need to be disclosed while applying for the certificate of practice as it was the information called for in the application, by the Institute.

Conclusion: Thus, Mr. G will be held guilty of professional misconduct under Clause (2) of Part III of First Schedule of the Chartered Accountants Act, 1949.

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Illustration 27

Mr. X, a Chartered Accountant, employed as a paid Assistant with a Chartered Accountant firm, leaves the services of the firm on 31st December, 2024. Despite many reminders from ICAI he fails to reply regarding the date of leaving the services of the firm.

Failed to Supply Information Called For: As per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949, a member, whether in practice or not, will be deemed to be guilty of professional misconduct if he does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate authority.

Conclusion: Thus, in the given case, Mr. X has failed to reply to the letters of the Institute asking him to confirm the date of leaving the service as a paid assistant. Therefore, he is held guilty of professional misconduct as per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949.

Clause (3) while inviting professional work from another chartered accountant or while responding to tenders or enquiries or while advertising through a write up, or anything as provided for in items (6) and (7) of Part I of this Schedule, gives information knowing it to be false.

Any member of the Institute, in the course of procurement of professional work from another Chartered Accountant or from any other source provides or renders any information which he knows to be false through any documents, or acts (like tenders, enquiries, response to advertisement, CV type write ups etc.), he would be deemed guilty of professional misconduct under Clause (3), Part III of First Schedule.

PART IV- Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he -

Clause (1) is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months.

Clause (2) in the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

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Illustration 28

YKS & Co., a proprietary firm of Chartered Accountants, was appointed as a concurrent auditor of a bank. YKS, the proprietor, used his influence to get a loan and thereafter failed to repay the loan.

Disrepute to the Profession: This is a case which is covered under the expression in other misconduct of the Chartered Accountants Act, 1949. As per Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he, in the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work. Here the Chartered Accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards calls for disciplinary action.

In the present case, YKS & Co, being a concurrent auditor, used his position to obtain the funds and failed to repay the same to the bank. This brings disrepute to the profession of a Chartered Accountant. This act of YKS & Co is not pardonable.

Conclusion: Therefore, YKS & Co will be held guilty of other misconduct under Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949.

These Clauses (1) & (2) are self-explanatory and any of the member of the Institute is found guilty by any civil or criminal court and prosecuted for an imprisonment in an offence involving moral turpitude or his acts bring disrepute to the profession or the Institute, irrespective of the fact whether such acts are related to profession or not, such member will be deemed to be guilty of other misconduct in Part IV of First Schedule.

The important point to note is that if imprisonment tenure exceeds six months, this case will be covered in the Clause of Part III of Second Schedule.

8.2 The Second Schedule

Where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the second schedule or in both the Schedule, he shall place the matter before the Disciplinary Committee.

Part I - Professional Misconduct in relation to Chartered Accountants in Practice

A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he-

Clause (1) Discloses Information acquired in the course of his professional engagement to any person other than his client so engaging him without the consent of his client or otherwise than as required by any law for the time being in force.

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An accountant in public practice has access to a great deal of information of his client, which is of a highly confidential character. It is important for the work of an accountant and for maintaining the dignity and status of the profession that he should treat such information as having been provided to him, only to facilitate the performance of his professional duties for which his services have been engaged. To divulge such information would be a breach of professional confidence, which may give rise to the most serious consequences, even to an action by the client for the loss suffered by him through such a breach. The accountant's duty not to disclose continues even after the completion of his assignment.

If disclosure is required as a part of performance of professional duty by a practicing member in relation to a client, the fact that such performance is required by the client would itself amount to the client consenting to such disclosure. Thus, a member in practice submitting information to, say, exchange control authorities, while performing his professional duties cannot be considered to have made disclosure without the aforesaid consent. But, in all cases, the request or the initiative that the members does prefer the service, which would entail such disclosure, must come from the client in relation to whose affairs the disclosure would be entailed.

If disclosure is required in other cases, it would be necessary to ensure that the consent of the client is given by a person who is competent to accord such consent. Thus, in the case of a sole proprietary concern, the consent may be given by the proprietor or his constituted attorney who is legally empowered to give such consent. In the case of partnership firm, since in turn, every partner has the authority to bind the firm by his acts, the consent may be given by any partner. In the case of a company, by virtue of section 179 of the Companies Act, 2013, the Board of Directors is empowered to do all that the company in a general meeting may do unless a resolution by the company in general meeting is required by the Act or by the Memorandum or Articles of the company. Hence, the consent may be sought from the Managing Director if the powers of the Board of Directors are delegated to him comprehensively enough to include the power to give such consent, but if the powers of the Board of Directors are not so delegated, the consent should be obtained by means of resolution of the Board of Directors of the Company.

An auditor is not required to provide the client or other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor. For this purpose, the term 'auditor' includes 'internal auditor'.

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However, the auditor may, at his discretion, in cases considered appropriate by him, make portions of or extracts from his working papers available to the client.

There is a difference between sharing of working papers and sharing of information. So far as the information is concerned, he can provide the same to the client or to a Regulatory body after obtaining the consent of the client.

It is not possible to set out all the circumstances under which disclosure of information may be required by law. If under any legal compulsion and if it is not legally permissible to claim privilege under the Evidence Act, 1872 (Section 126), the disclosure made by a member of such information may not be considered as misconduct. However, such matters involve niceties of law and expert legal advice may be sought prior to such disclosure.

The only circumstance in which this duty of confidence may give rise to a difficulty is where the accountant has reason to believe that the client has been guilty of some unlawful act or default. This matter is of special significance in the case where the client is guilty of tax evasion.

Further, students may note that as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Illustration 29

Mr. P, a Chartered Accountant was invited by the Chamber of Commerce to present a paper in a symposium on the issues facing Indian Leather Industry. During the course of his presentation, he shared some of the vital information of his client's business under the impression that it will help the Nation to compete with other countries at international level.

Disclosure of Client's Information: Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 deals with the professional misconduct relating to the disclosure of information by a chartered accountant in practice relating to the business of his clients to any person other than his client without the consent of his client or otherwise than as required by any law for the time being in force would amount to breach of conduct. The Code of Ethics further clarifies that such a duty continues even after completion of the assignment. The Chartered Accountant may however, disclose the information in case it is required as a part of performance of his professional duties. In the given case, Mr. Ph has disclosed vital information of his client's business without the consent of the client under the impression that it will help the nation to compete with other countries at International level.

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Conclusion: Thus, it is a professional misconduct covered by Clause (1) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Clause (2) Certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice.

The above clause restrains a member from subscribing to the report on a financial statement so long as it has not been examined by him or by a partner or an employee of his firm or by another chartered accountant in practice. It has been introduced to ensure that the work entrusted to him has been carried out by the member either directly or under his supervision before he renders his report.

An exception however has been made in respect of an examination carried out by another chartered accountant in practice. This enables two or more members to accept a joint assignment or enables a member also to carry out the examination of financial statements by or with the assistance of all or either any chartered accountant in practice.

Where the joint auditors are appointed, the work is normally divided among themselves in terms of identifiable units or areas, or with reference to the items of liabilities, or income or expenditure or to the period of time etc. Such division should be adequately documented and communicated to the auditee.

In the course of his work, where a joint auditor comes across matters requiring discussion with or application of judgement by the joint auditors, he must communicate to the other joint auditors before submission of the report.

In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible in accordance with SA 299 “Joint Audit of Financial Statements”:

Each joint auditor should decide for himself the appropriateness of using test checks or sampling, the nature, timing and extent of audit procedures to be applied in relation to the work allotted to him.

Obtaining and evaluating the information and explanations from the management is the joint responsibility of the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In case of distribution of the responsibility, the liability of the joint auditors is limited to the area allotted to that auditor.

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Clause (3) Permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast.

As per the opinion of the Council while finalising the Guidance Note on Accountant's Report on Profit Forecasts and/or Financial Forecasts at its 100th meeting held on 22nd through 24th July 1982, a chartered accountant can participate in the preparation of profit or financial forecasts and can review them, provided he indicates clearly in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and so long as he does not vouch for the accuracy of the forecasts. The Council has further opined that the same opinion would also apply to projections made on the basis of hypothetical assumptions about future events and management actions which are not necessarily expected to take place so long as the auditor does not vouch for the accuracy of the projection.

Further, the attention of the members is drawn to **"Guidance Note on Reports in Company Prospectuses (Revised 2019)"** issued by the Council in January 2019. This Guidance Note provides guidance on compliance with the provisions of the Companies Act, 2013 and the **Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations 2018** relating to the reports required to be issued by chartered accountants in prospectus issued by the companies for the offerings made in India.

A Chartered Accountant issued 97 Projection Statements for certain Individuals without verifying the basic documents and on the basis of which the Bank had extended the loan amount. Afterwards, the Bank revealed that persons for whom the Respondent had issued Financial Statements did not have any business/source for repayment of loan. Accordingly, Chartered Accountant will be held, guilty of professional misconduct falling within the meaning of Clauses (3), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

Clause (4) Expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.

(i) If the opinions of auditors are to command respect and the confidence of the public, it is essential that it must be free of any interest which is likely to affect their independence. Since financial interest in the business can be a substantial interest and one of the important factors which may disturb independence, the existence of such an interest direct or indirect affects the opinion of the auditors. As per this clause, an auditor should not express his opinion on financial statements of any business or enterprise wherein he has a substantial interest. This is intended to assure the public as regards the faith and confidences that could be reposed on the independent opinion expressed by the auditors.

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(ii) For the purpose of this Clause, the expression "Substantial Interest" shall have meaning as is assigned thereto, under Appendix (9) of the Chartered Accountants Regulations, 1988. (**see Clause 11 of Part I of First Schedule**).

(iii) The words "financial statements" used in this clause would cover both reports and certificates usually given after an examination of the accounts or the financial statement or any attest function under any statutory enactment or for purposes of income-tax assessments. This would not, however, apply to cases where such statements are prepared by members in employment purely for the information of their respective employers in the normal course of their duties and not meant to be submitted to any outside authority.

(iv) Public conscience is expected to be ahead of the law. Members, therefore, are expected to interpret the requirement as regards independence much more strictly than what the law requires and should not place themselves in positions which would either compromise or jeopardise their independence.

(v) Member must take care to see that they do not land themselves in situations where there could be conflict of interest and duty.



6. For example, where a Chartered Accountant is appointed the Liquidator of a Company, he should not qua a Chartered Accountant himself, audit the Statement of Accounts to be filed under Section 348(1) of the Companies Act, 2013. The audit in such circumstances should be done by a Chartered Accountant other than the one who is the Liquidator of the Company.

(vi) In this connection, the Council has decided not to permit a Chartered Accountant in employment to certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he holds certificate of practice and that such certification can be done by any Chartered Accountant in practice. This restriction would not however apply where the certification is permitted by any law. The Council has also decided that a Chartered Accountant should not by himself or in his firm name:-

a. accept the Auditorship of a college, if he is working as a part-time lecturer in the college.

b. accept the Auditorship of a Trust where his partner is either an employee or a trustee of the Trust.

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The Council has, in this connection, issued the following guidelines:

Requirements of Clause applicable to all Attest Functions

(vii) Many new areas of professional work have been added, e.g., Tax Audit, GST Audit, Concurrent Audit of Banks, Concurrent Audit of Borrowers of Financial institutions, Audit of non-corporate borrowers of Banks and Financial Institutions, Audit of Stock Exchange, Brokers, etc. The Council wishes to emphasize that the aforesaid requirement of Clause (4) are equally applicable while performing all types of attest functions by the members.

(viii) Some of the situations which may arise in the applicability of Clause (4) read with the definition of "Substantial Interest" (**see Clause 11 of Part I of First Schedule**).and other statutory prohibitions are discussed below for the guidance of members:-

1. Where the member, his firm or his partner or his relative has substantial interest in the business or enterprise (not being a company).

   The independence of mind is a fundamental concept of audit and/or expression of opinion on the financial statements in any form and, therefore, must always be maintained. Nothing can substitute for the essential and fundamental requirements of independence. Therefore, the Council's views are clarified in the following circumstances.

   (a) An enterprise/concern of which a member is either an owner or a partner

   The holding of interest in the business or enterprise (not being a company) by a member himself whether as sole-proprietor or partner in a firm, in the opinion of the Council, would affect his independence of mind in the performance of professional duties in conducting the audit and/or expressing an opinion on financial statements of such enterprise. Therefore, a member shall not audit financial statements of such business or enterprise.

   (b) Where the partner or relative of a member has substantial interest

   The holding of substantial interest by the partner or relative of the member in the business or enterprise (not being a company) of which the audit is to be carried out and opinion is to be expressed on the financial statement, may also affect the independence of mind of the member, in the opinion of Council, in the performance of professional duties. Therefore, the member may, for the same reasons as not to compromise his independence, desist from undertaking the audit of financial statements of such business or enterprise.

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2. Where the member or his partner or relative is a director or in the employment of an Officer or an Employee of the Company.

(a) Where the member is holding a position in the Company as Director, officer or employee

Section 141(3)(b) of the Companies Act, 2013 specifically prohibits a member from auditing the accounts of a Company in which he is an officer or employee of the Company, or in the employment of an officer or an employee of the Company (irrespective of the question of substantial interest).

Moreover, in case the member who is Director Simplicitor (general permission) in a Company, the Council has prohibited such member from auditing the accounts of a Company, whether or not he holds substantial interest in the Company.

In case the member seeks specific permission of the Council to be Whole Time or Managing Director in a Company, he would, on grant of such permission, not be entitled either to engage in attest functions (which includes audit), or to hold substantial interest in the Company. Although the provisions of the aforesaid section are not specifically applicable in the context of audits performed under other statutes, e.g. Tax Audit, yet the underlying principle of independence of mind is equally applicable in those situations also.

(b) Where the member is not holding a position in the Company, but holding any security or interest

Section 141(3) (d)(i) of the Companies Act, 2013 disqualifies a person from being Auditor of a Company, if he holds any security or interest in the Company, or its subsidiary, or holding or associate company or a subsidiary of such holding Company.

(c) Where the partner of the member is an officer or employee of a company

Section 141(3)(c) of the Companies Act, 2013 disqualifies a member from being the auditor of a Company, where the partner of such member is an officer or employee of the Company.

(d) Where the partner of the member is holding any security or interest in the Company

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Section 141(3) (d)(i) of the Companies Act, 2013 bars a person from being auditor of a Company, if his partner holds any security or interest in the Company, or its subsidiary, or holding or associate company or a subsidiary of such holding Company.

(e) Where the relative of the member is a director or is in the employment of the Company as a director or key managerial person

Section 141 (3) (f) of the Companies Act, 2013 bars a person from accepting audit of a Company where the relative of the member is director or is in the employment of the Company as a director or key managerial person.

(f) Where the relative of the member is holding any security or interest in the Company

Section 141(3)(d) (i) of the Companies Act, 2013, read with Rule 10 of Companies (Audit and Auditors) Rules, 2014 bars a person from being auditor of a Company, if his relative holds security or interest in the Company, or its subsidiary, or holding or associate company or a subsidiary of such holding Company of face value exceeding Rupees One Lakh.

(ix) It is not permissible for a member to undertake the assignment of certification, wherein the client is relative of the member. The "relative" for this purpose would refer to the definition mentioned in Accounting Standard (AS)-18.

(x) An accountant is expected to be no less independent in the discharge of his duties as a tax consultant or as a financial adviser than as auditor. In fact, it is necessary that he should bear the same degree of integrity and independence of mind in all spheres of his work. Unless this is done, the accounts of entities audited by Chartered Accountants or statements made by them during the course of assessment proceedings would not be relied upon as correct by the authorities.

(xi) **Members not to write Books of Account for auditee clients:** The Council has clarified that the members are not permitted to write the books of account of their auditee clients.

(xii) **Statutory auditor not to be the Internal Auditor simultaneously**: An Auditor appointed by an entity under the Companies Act or any other statute shall not be the Internal Auditor of the same entity.

(xiii) **Internal auditor not to be the Tax auditor simultaneously:** An Internal Auditor of an assessee, whether working with the organization or an independently practicing Chartered

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Accountant irrespective of being an individual Chartered Accountant or a firm of Chartered Accountants cannot be appointed as its Tax Auditor.

(xiv) **Internal Auditor not to be the GST Auditor simultaneously:** The Internal Auditor of an entity cannot undertake GST Audit of the same entity.

(xv) **Cooling off period after completion of tenure as Director:** A member shall not accept the assignment of audit of a Company for a period of two years from the date of completion of his tenure as Director, or resignation as Director of the said Company.

(xvi) **Members to satisfy whether appointment is as per the statute:** A member should satisfy himself before accepting an appointment as an auditor of an entity that his appointment is in accordance with the statute governing the entity. In case the entity is constituted under a trust deed/instrument, the member should satisfy whether his appointment is valid according to the instrument constituting the entity and rules and regulations made thereunder.

(xvii) In case the appointment is to be authorised by the regulatory authorities such as in the case of co-operative societies, trusts etc. then the member must satisfy whether such regulatory authorities have authorised the managing committee of the society/trust for appointment of the auditors. In a case where any entity is being managed by a Managing Committee or Board of Trustees or Board of Governors by whatever name called he should ensure that his appointment is duly made by a resolution passed of such Managing Committee or Board of Trustees or Board of Governors. Even in case of partnership or sole proprietary concerns, the member must ensure that a letter of appointment/engagement is given by the firm/sole proprietor before he accepts the appointment/ engagement.

(xviii) Section 288 of Income-tax Act, 1961 describe the disqualifications for the purpose of Tax Audit.

Clause (5) fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.

It may be observed that this clause refers to failure to disclose a material fact, which is known to him, in a financial statement reported on by the auditor. It is obvious, that before a member could be held guilty of misconduct, materiality has to be established. The determination of materiality has been provided in SA 320, “Materiality in Planning and Performing an Audit”.

It should be borne in mind that there may be cases where an item may not be material from the point of view of the balance sheet, but may have material significance in relation to the profit and loss account for that year and vice-versa. It is therefore essential that care should be taken to ensure

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that the aspect of materiality should be judged in relation to both the balance sheet and the profit and loss account.

The word "financial statements" used in this clause would cover both reports and certificate usually given after an examination of the accounts or of financial statements under any statutory enactment, or/for purposes of income tax assessments. This would not however, apply to cases where such statements are prepared by members in employment purely for the information of their respective employers in the normal course of their duties and not meant to be submitted to any outside authority.

Illustration 30

Mr. J, a Chartered Accountant during the course of audit of M/s XYZ Ltd. came to know that the company has taken a loan of ₹ 10 lakhs from Employees Provident Fund. The said loan was not reflected in the books of account. However, the auditor ignored this information in his report.

Failure to Disclose Material Facts: As per Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered Accountant in practice will be held liable for misconduct if he fails to disclose a material fact known to him, which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading. In this case, Mr. J has come across information that a loan of ₹ 10 lakhs has been taken by the company from Employees Provident Fund. This is contravention of Rules and the said loan has not been reflected in the books of accounts. Further, this material fact has also to be disclosed in the financial statements. The very fact that Mr. J has failed to disclose this fact in his report, he is attracted by the provisions of professional misconduct under Clause (5).

Conclusion: Mr. J will be liable of professional misconduct under Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Clause (6) Fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

This clause refers to failure on the part of a member to point out in his report a material misstatement appearing in a financial statement and he has knowledge of the same. Here also, it is obvious, that before a member could be held guilty of misconduct, materiality has to be established and the observations made under the preceding Clause (5), in this connection, will equally apply to this clause.

Illustration 31

A practicing Chartered Accountant was appointed to represent a company before the tax authorities. He submitted certain information and explanations to the authorities on behalf of his clients, which were found to be false and misleading.

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Submitting Information as Authorised Representative: As per Clause (5) of Part I of Second Schedule to the Chartered Accountant Act, 1949, if a member in practice fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading, where he is concerned with that financial statement in a professional capacity, he will be held guilty under Clause (5). As per Clause (6) of Part I of Second Schedule if he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity, he will be held guilty under Clause (6).

In given case, the Chartered Accountant had submitted the statements before the taxation authorities. These statements are based on the data provided by the management of the company. Although the statements prepared were based on incorrect facts and misleading, the Chartered Accountant had only submitted them acting on the instructions of his client as his authorized representative.

Conclusion: Hence, the Chartered Accountant would not be held liable for professional misconduct.

Clause (7) does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

Though very simply worded, it is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence. The meaning and significance of this clause is well contained in the following passage quoted from the Judgement of the Karnataka High Court in a disciplinary case which came before it in 1977:

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog but not a bloodhound. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful."

Professional misconduct is a term of fairly wide import but generally speaking, it implies fairly serious cases of misconduct of gross negligence. Negligence per se would not amount to gross negligence in the case of minor errors and lapses, which do not constitute professional misconduct and which, therefore, don't require a reference to the Disciplinary Committee, the Council would nevertheless bring the matter to the attention of its members so that greater care may be taken in the future in avoiding errors and lapses of a similar type.

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Illustration 32

CA C who conducted statutory audit of a Haryana daily 'New Era' certified the circulation figures based on Management Information System Report (M.I.S Report) without examining the books of Account.

Failed to exercise Due Diligence: According to Clause (7) of Part I of Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he "does not exercise due diligence or is grossly negligent in the conduct of his professional duties".

In the instant case, CA C did not exercise due diligence and is grossly negligent in the conduct of his professional duties since he certified the circulation figures without examining the books of accounts.

To ascertain the number of paid copies verification of remittances from the agents, credit allowed to the agents for unsold copies returned, examination of books of account is essential. Further certification of circulation figures based on statistical information without cross verification with financial records amounts to gross negligence and failure to exercise due diligence.

Conclusion: Hence, CA C is guilty of professional misconduct as per Clause (7) of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Illustration 33

Mr. D, a practicing Chartered Accountant, did not complete his work relating to the audit of the accounts of a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirements.

Not Exercising Due Diligence: According to Clause (7) of Part I of Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

It is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence.

Where a Chartered Accountant had not completed his work relating to the audit of the accounts a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirement in this regard. He was guilty of professional misconduct under Clause (7).

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Since Mr. D has not completed his audit work in time and consequently could not submit audit report in due time and consequently, company could not comply with the statutory requirements.

Conclusion: Therefore, the auditor is guilty of professional misconduct under Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

Clause (8): Fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.

It is expected of a Chartered Accountant to express his opinion on the truth and fairness of statements of accounts after examining their authenticity with reference to information and explanations given to him. A Chartered Accountant must determine the extent of information, which, should be obtained by him before he expresses an opinion on the financial statements submitted to him for report.

The chartered accountant should not express an opinion before obtaining the required data and information. The latter part of the clause enjoins that where due to inadequacy of information or data the report has to be circumscribed to an extent that it would cease to be of any expression of a categorical opinion, the auditor should clearly express his disclaimer in no uncertain terms.



7. For example, if the auditor has not seen any evidence of the existence and/or valuation of the investment which constitute the only asset of a company, he should not say that:

"Subject to the verification of the existence and value of the investments the balance sheet shows a true and fair view etc."

For manner of auditor's reporting in such situations, reference may be made to SA 705(Revised), "Modifications to the Opinion in the Independent Auditor's Report".

Where a Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e. by not looking into the financial records, bank statements or bank pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for. Held he was guilty under Clause (8). *[Registrar of Newspapers for India vs K. Rajinder Singh (1971)]*

"a certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion." A Chartered Accountant is required to clearly state his limitations/assumptions in his certificates, while in the said matter, the Respondent in none of the 12 certificates either mentioned his limitation or assumptions. Though, in his written

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statements he submitted that his job was not to verify the assets physically or verification of original bills or whether promoters contribution have come in actually in the Bank account etc. If his assignment did not include the same, he ought to have disclosed or mentioned in the certificates that while issuing the certificate he had relied upon the following documents, so as not to mislead the users of the said certificate(s). In the instant matter, the Respondent did not disclose any assumptions/limitations whatsoever while issuing the certificates. Moreover, the Respondent in none of the certificates issued by him had mentioned the basis/papers relied upon by him. Consequently, the same misled the IDBI Bank in approving the loan based on such certificates which did not mention the basis of issuance.

The Respondent while issuing the Certificates ought to have exercised diligence but he failed to do so. Accordingly, the Committee is of the view that the Respondent was grossly negligent in conduct of his professional duties and also failed to obtain sufficient information while issuing the aforestated certificates. Thus, he was guilty under clause (7) and (8).

The Committee noted that since the transaction of land took place between the Shivdarshan Firm i.e., a partnership firm and Siddheshwari Developers, the same should have been reflected in the books of Shivdarshan Firm and not in the books of Shivdarshan Construction which was a proprietary concern. The Respondent being the auditor of Shivdarshan Construction failed to report the said discrepancy in his audit report. Since, the amount of loan was material and the Respondent failed to submit any evidence based on which he had chosen not to qualify the appearance of housing loan from Navsarjan Industrial Co. Op. Bank Ltd in the financial statements, hence, the Committee is of the view that the Respondent is guilty of professional misconduct falling within the meaning of Clauses (6), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 *[Shri Mukesh M. Kelawala vs. CA Sukhdev Manilal Soni (2013)]*

Where the Respondent had failed to report on the Bank Account which was opened by the client in the capacity as a proprietor which included lot of variations, i.e., Account Number was different and the capacity in which Account was opened was also different. As a Professional, the Respondent ought to have copies of Bank Account which could easily establish the fact that the Bank Account was opened and operated proprietary name but he could not do that. Hence, it was observed that the Respondent was not only negligent in his duties in respect of auditing of bank transactions but also, failed to obtain sufficient information for expressing an opinion. The Respondent was held guilty of professional misconduct falling within the meaning of Clauses (7) & (8) of Part I of the Second Schedule to the Chartered Accountants Act 1949. *[P. Arun vs. N. Raja Ganesh, (2014)]*

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Illustration 34

Mr. A, a Chartered Accountant, was the auditor of 'A Limited'. During the financial year 2023-24, the investment appeared in the Balance Sheet of the company of ₹ 12 lakh and was the same amount as in the last year. Later on, it was found that the company's investments were only ₹ 25,000, but the value of investments was inflated for the purpose of obtaining higher amount of Bank loan.

Grossly Negligent in Conduct of Duties: As per Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he, certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice, under Clause (2); does not exercise due diligence, or is grossly negligent in the conduct of his professional duties, under Clause (7); or fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion, under Clause (8).

The primary duty of physical verification and valuation of investments is of the management. However, the auditor's duty is also to verify the physical existence and valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the Management's representation.

In the instant case, such non-verification happened for two years. It also appears that auditors failed to confirm the value of investments from any proper source. In case auditor has simply relied on the management's representation, the auditor has failed to perform his duty.

Conclusion: Accordingly, Mr. A, will be held liable for professional misconduct under Clauses (2), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

Clause (9) Fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

This clause implies that the audit should be performed in accordance with "generally accepted procedure of audit applicable to the circumstances" and if for any reason the auditor has not been able to perform the audit in accordance with such procedure, his report should draw attention to the material departures from such procedures. What constitutes "generally accepted audit procedure" would depend upon the facts and circumstances of each case, but guidance is available in general

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terms from the various pronouncements of the Institute is issued by way of Engagement and Quality Control Standards, Statements, General Clarifications, Guidance Notes Technical Guides, Practice Manuals, Studies and Other Papers. (ref.)

Audit of Listed Companies: Pursuant to SEBI Notification, Statutory Audit of Listed Companies under the Companies Act, 2013 shall be done by only those auditors who have subjected themselves to the Peer Review process of the Institute, and hold a valid certificate issued by the Peer Review Board of the ICAI.

FRN and Membership No.: The members are required to mention the Membership number and Firm registration number to all reports issued pursuant to any attestation engagements, including certificates, issued by them as proprietor of/ partner in the said firm.

Unique Document Identification Number (UDIN): The members may note that UDIN is mandatory from 1st July, 2019 on all Corporate/ Non- Corporate Audit, Attest and Assurance Functions. Thus, a member of the Institute in practice shall generate Unique Document Identification Number (UDIN) for all kinds of the certification, GST and Tax Audit Reports and other Audit, Assurance and Attestation functions undertaken/signed by him.

An auditor of a company is appointed by the shareholders to perform certain statutory functions and duties and it is expected of him that he will in fact, perform these functions and duties. The failure to perform a statutory duty in the manner required is not excused merely by giving a qualification or reservation in auditor's report.



8. For example, if an auditor fails to verify the cash balance in circumstances where such verification was necessary, feasible and material, it is not sufficient for him merely to state in his report that he did not verify the cash balance in circumstances when giving any reservations or qualifications in the auditor's report as required under this clause, a member would be well advised to indicate clearly the reasons why he was unable to perform the audit in accordance with generally accepted procedures and standards.

It is not possible to exhaustively deal with instances or accepted procedure of audit applicable to special cases. **Two instances** of an audit requiring a special procedure are given below:

Certifying figures of circulation of Newspapers etc.: Very often members are required to certify the figures of circulation of newspapers, magazines etc. by their clients on behalf of the Audit Bureau of Circulations Ltd. Members are normally supplied by the ABC with the Rules and Regulations under which the certification of circulation is to be carried out. Members are also asked to give their acceptance in writing that they will observe the rules of procedure envisaged to report upon any lapse of such special requirements, even of an insignificant nature.

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Verification on behalf of Banks: Similarly, in the case of verification on behalf of banks, the rules or procedure for conducting such audit are different from the normal rules applicable to audits under the Companies Act. Members are required to be very familiar with the special procedure required in these matters and act accordingly.

Clause (10) fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

In the course of his engagement as a professional accountant, a member may be entrusted with moneys belonging to his client. If he should receive such funds, it would be his duty to deposit them in a separate banking account, and to utilize such funds only in accordance with the instructions of the client or for the purposes intended by the client. In this connection the Council has considered some practical difficulties of the members and the following suggestions have been made to remove these difficulties:

(i) An advance received by a Chartered Accountant against services to be rendered does not fall under Clause (10) of Part I of the Second Schedule.

(ii) Moneys received for expenses to be incurred, for example, payment of prescribed statutory fees, purchase of stamp paper etc., which are intended to be spent within a reasonably short time need not be put in a separate bank account. For this purpose, the expression; "reasonably short time", would depend upon the circumstances of each case.

(iii) Moneys received for expenses to be incurred which are not intended to be spent within a reasonably short time as aforesaid, should be put in a separate bank account immediately.

(iv) Moneys received by a Chartered Accountant, in his capacity as trustee, executor liquidator, etc. must be put in a separate bank account immediately.

Illustration 35

A charitable institution entrusted ₹10 lakhs with its auditors M/s R & Co., a Chartered Accountant firm, to invest in a specified securities. The auditors deposited it in their Savings bank account and no investment was made in the next three months.

Failure to Keep Money in Separate Bank Account: If a Chartered Accountant in practice fails to keep moneys of his clients in a separate bank account or fails to use such moneys for purposes for which they are intended then his action would amount to professional misconduct under Clause (10) of Part I of Second Schedule to the Chartered Accountants Act, 1949. In the course of his engagement as a professional accountant, a member may be entrusted with moneys belonging to his client. If he should receive such funds, it would be his duty to deposit them in a separate

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banking account, and to utilise such funds only in accordance with the instructions of the client or for the purposes intended by the client.

Conclusion: In the given case by depositing the client's money by M/s R & Co., a firm of Chartered Accountants, in their own savings bank account, the auditors have committed professional misconduct. Hence in the given case, M/s R & Co. will be held guilty of professional misconduct.

PART II - Professional misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he -

Clause (1) contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

This clause is very important. It requires every member of the Institute to act within the framework of the Chartered Accountants Act and the Regulations and Guidelines made by Council thereunder. Any violation either of these Guidelines or the Act or the Regulations by a member would amount to misconduct under this part.

The Regulations under which cases of contravention have generally come to the notice of the Council are the following:

Regulation 43	Engagement of Articled Assistant
Regulation 46	Registration of Articled Assistant
Regulation 47	Premium from Articled Assistant
Regulation 48	Stipend to Articled Assistant
Regulation 56	Termination or assignment of Articles
Regulation 65	Articled Assistant not to engage in any other occupation
Regulation 67	Complaint against the employer (from Articled Assistant)
Regulation 68 to 80	Audit Assistant
Regulation 190	Register of offices and firms
Regulation 190-A	Chartered Accountants not to engage in any other business or occupation
Regulation 191	Part time employment's a Chartered Accountant may accept
Regulation 192	Restriction on fees

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Clause (2) being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer.

This is an adaptation of the well-accepted principle of the law of agency. A member in the forthcoming circumstance would be guilty of misconduct regardless of the fact that he was in whole time or part-time employment or that he was carrying on practice of accountancy along with his employment. Since as employee, a member may have access to a confidential information, hence for maintaining the status and dignity of the profession in general, he should treat such information as having been provided to him only to facilitate the performance of his duties as an employee. In order to keep the confidence of the people, Chartered Accountants, should take special care not to divulge such information.

Clause (3) includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline. Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

If a Chartered Accountant includes in any information, statement, return or form to be submitted to the Institute Council etc. any particular knowing it to be false, he will be held guilty of misconduct.

Where a Chartered Accountant who was employed as a manager of a firm of Registered Accountants, applied for admission as Fellow of the Institute stating that he was a partner, while he was not. Held that the Chartered Accountant was guilty of misconduct as he had made the statement that he was a partner knowing it to be false. *[J.R. Chatrath, (1952)]*

A Member had during the course of the hearing before Disciplinary Committee given a wrong statement duly verified and also a statement on oath knowing it to be false. He was found guilty in terms of this clause. *[K.S. Dugar, (1987)]*

In spite of repeated reminders a Chartered Accountant failed to reply to the letters of the Institute asking him to confirm the date of leaving the services by the Paid Assistant. Held, the Chartered Accountant was guilty of professional misconduct under the Clause. *[A. Umanath Rao, [1965)]*

Clause (4) defalcates or embezzles money received in his professional capacity.

Defalcation and embezzlement of moneys received in professional capacity amounts to fraud (Covered in SA-240) and such member will be deemed to be guilty of professional misconduct under this clause.

Clause (5) acts as an auditor of the company in contravention of the provisions of the Companies Act, 2013.

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Part III - Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

Imprisonment awarded for a term exceeding six months in any civil/criminal matter treated as a major offence under 'other misconduct' is included in this Schedule.

9 COUNCIL GUIDELINES

The relevant extracts of the **Council General Guidelines, 2008** ***(issued under Clause (1) of Part-II of Second Schedule to The Chartered Accountants Act, 1949) are given below:***

Chapter I

Preliminary

1.0 Short title, commencement, etc.

(a) These Guidelines have been issued by the Council of the Institute of Chartered Accountants of India under the provisions of The Chartered Accountants Act, 1949, as amended by The Chartered Accountants (Amendment) Act 2006, These Guidelines be called the 'Council General Guidelines, 2008'.

(b) These guidelines shall be applicable to all the Members of the Institute whether in practice or not wherever the context so requires.

Chapter II

Conduct of a Member being an employee

A member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

Chapter III

Appointment of a Member as Cost auditor

This Chapter is being omitted.

Chapter IV

Opinion on financial statements when there is substantial interest

This Chapter is being omitted.

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Chapter V

Maintenance of books of account

A member of the Institute in practice or the firm of Chartered Accountants of which he is a partner, shall maintain and keep in respect of his / its professional practice, proper books of account including the following-

(i) a Cash Book;

(ii) a Ledger.

Illustration 36

L, a chartered accountant did not maintain books of account for his professional earnings on the ground that his income is less than the limits prescribed u/s 44AA of the Income Tax Act, 1961.

Maintenance of Books of Account: As per the Council General Guidelines 2008, under Chapter 5 on maintenance of books of accounts, it is specified that if a chartered accountant in practice or the firm of Chartered Accountants of which he is a partner fails to maintain and keep in respect of his/its professional practice, proper books of account including the Cash Book and Ledger, he is deemed to be guilty of professional misconduct. Accordingly, it does not matter whether section 44AA of the Income Tax Act, 1961 applies or not.

Conclusion: Hence, Mr. L is guilty of professional misconduct.

Chapter VI

Tax Audit assignments under Section 44 AB of the Income-tax Act, 1961

A member of the Institute in practice shall not accept, in a financial year, more than the "specified number of tax audit assignments" under Section 44AB of the Income-tax Act, 1961.

Provided that in the case of a firm of Chartered Accountants in practice, the "specified number of tax audit assignments" shall be construed as the specified number of tax audit assignments for every partner of the firm.

Provided further that where any partner of the firm is also a partner of any other firm or firms of Chartered Accountants in practice, the number of tax audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the "specified number of tax audit assignments" in the aggregate.

Provided further that where any partner of a firm of Chartered Accountants in practice accepts one or more tax audit assignments in his individual capacity, the total number of such assignments which

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may be accepted by him shall not exceed the "specified number of tax audit assignments" in the aggregate.

Provided also that the audits conducted under Section 44AD, 44ADA[1] *and 44AE of the Income Tax Act, 1961 shall not be taken into account for the purpose of reckoning the "specified number of tax audit assignments".*

Explanation:

For the above purpose, "the specified number of tax audit assignments" means -

(a) in the case of a Chartered Accountant in practice or a proprietary firm of Chartered Accountant, **60 tax audit assignments, in a financial year, whether in respect of corporate or non-corporate assesses.

(b) in the case of firm of Chartered Accountants in practice, **60 tax audit assignments per partner in the firm, in a financial year, whether in respect of corporate or non-corporate assesses.

> According to a clarification on Tax Audit Assignments by Committee on Ethical Standards Board) of the Institute, if there are 10 partners in a firm of Chartered Accountants in practice, then all the partners of the firm can collectively sign 600 tax audit reports. This maximum limit of 600 tax audit assignments may be distributed between the partners in any manner whatsoever. For instance, 1 partner can individually sign 600 tax audit reports in case remaining 9 partners are not signing any tax audit report.

In computing the "specified number of tax audit assignments" each year's audit would be taken as a separate assignment.

In computing the "specified number of tax audit assignments", the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other Chartered Accountant in practice or firm of such Chartered Accountants, shall be taken into account.

The audit of the head office and branch offices of a concern shall be regarded as one tax audit assignment.

The audit of one or more branches of the same concern by one Chartered Accountant in practice shall be construed as only one tax audit assignment.

[1] As inserted by the Council pursuant to decision at its 368th Meeting held on 10th to 12th Aug., 2017 (Section 44AF, earlier appearing, was repealed).

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A Chartered Accountant being a part time practicing partner of a firm shall not be taken into account for the purpose of reckoning the tax audit assignments of the firm.

A Chartered Accountant in practice shall maintain a record of the tax audit assignments accepted by him in each assessment year in the format as may be prescribed by the Council.

The limit on number of tax audit assignments per partner in a CA Firm may be distributed between the partners in any manner whatsoever. However, it should be in accordance with the Standard on Quality Control (SQC) 1: Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

Illustration 37

A member of the institute shall not accept in a year more than the specified number of tax audits under section 44AB of the Income Tax Act.

Mr. G is a partner in M/s. XYZ & Co., a firm of Chartered Accountants with 6 partners.

During the assessment year 2023-24, Mr. G alone had signed 290 tax audit reports consisting of both corporate and non-corporate assesses.

Ceiling limit for signing the Tax Audit Reports: As per Council General Guidelines 2008, a member of the Institute in practice shall not accept, in a financial year, more than the "specified number of tax audit assignments" under Section 44AB of the Income-tax Act, 1961. It is also provided further that where any partner of a firm of Chartered Accountants in practice accepts one or more tax audit assignments in his individual capacity, the total number of such assignments which may be accepted by him shall not exceed the "specified number of tax audit assignments" in the aggregate.

In the case of firm of Chartered Accountants in practice "the specified number of tax audit assignments" means 60 tax audit assignments per partner in the firm, in a financial year, whether in respect of corporate or non-corporate assesses.

Further, as per clarification issued by the Institute on Tax Audit Assignments, tax audit reports may be signed by the partners in any manner whosoever in accordance with specified audit limits. Thus, one partner can individually sign all the tax audit reports subject to specified tax audit assignment limits on behalf of all the partners in the firm of Chartered Accountants in practice or all the partners of the firm can collectively sign the tax audit reports.

In the instant case, there are 6 partners in M/s XYZ & Co., a Chartered Accountants firm, accordingly, specified ceiling limit for the firm will be (60 tax audit assignments per partner X 6 partners) = 360. Therefore, all the 6 partners of the firm can collectively sign 360 tax audit reports. This maximum limit of 360 tax audit assignments may be distributed between the partners in any manner whatsoever. For instance, 1 partner can individually sign 360 tax audit

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reports in case remaining 5 partners are not signing any tax audit report.

Assuming Mr. G has signed 290 tax audit reports consisting of both corporate and non-corporate assesse on behalf of firm and remaining partners are signing audit reports within the specified number of tax audit assignments u/s 44AB i.e. upto 70.

Conclusion: Hence, Mr. G shall not be deemed to guilty of professional misconduct provided total number of tax audit reports on behalf of firm do not exceeds 360.

Chapter VII
Appointment of an Auditor in case of non-payment of undisputed fees

A member of the Institute in practice shall not accept the appointment as auditor of an entity in case the undisputed audit fee of another Chartered Accountant for carrying out the statutory audit under the Companies Act, 2013 or various other statutes has not been paid:

Provided that in the case of sick unit, the above prohibition of acceptance shall not apply.

Explanation 1: For this purpose, the provision for audit fee in accounts signed by both - the auditee and the auditor along with other expenses, if any, incurred by the auditor in connection with the audit, shall be considered as "undisputed audit fees".

Explanation 2: For this purpose, "sick unit" shall mean a unit registered for not less than five years, which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.

Illustration 38

Mr. C accepted the statutory audit of M/s PSU Ltd., whose net worth is negative for the year 2022-23. The audit was to be conducted for the year 2023-24. The audited accounts for the year 2023-24 showed liability for payment of tax audit fees of ₹15,000 in favour of Mr. E, the previous auditor.

Accepting Appointment as an Auditor: As per Chapter 7 of Council General Guidelines 2008, a member of the Institute of Chartered Accountants of India in practice shall be deemed to be guilty of professional misconduct if he accepts appointment as auditor of an entity in case the undisputed audit fee of another chartered accountant for carrying out the statutory audit under the Companies Act, 2013 or various other statutes has not been paid.

As per the proviso, such prohibition shall not apply in case of a sick unit where a sick unit is defined to mean "where the net worth is negative".

Conclusion: In the instant case, though the undisputed fees are unpaid, Mr. C would still not be guilty of professional misconduct since the M/s PSU Ltd. is a sick unit having negative net worth for the year 2022-23.

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Chapter VIII

Specified number of audit assignments

A member of the Institute in practice shall not hold at any time appointment of more than the "specified number of audit assignments" of Companies under Section 141 of the Companies Act 2013.

Provided that in the case of a firm of Chartered Accountants in practice, the "specified number of audit assignments" shall be construed as the specific number of audit assignments for every partner of the firm.

Provided further that where any partner of the firm of Chartered Accountants in practice is also a partner of any other firm or firms of Chartered Accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the "specified number of audit assignments" in the aggregate.

Provided further where any partner of a firm or firms of Chartered Accountants in practice accepts one or more audit of Companies in his individual capacity, or in the name of his proprietary firm, the total number of such assignments which may be accepted by all firms in relation to such Chartered Accountant and by him shall not exceed the "specified number of audit assignments" in the aggregate.

Explanation:

1. For the above purpose, the "specified number of audit assignments" means –

   (a) in the case of a Chartered Accountant in practice or a proprietary firm of Chartered Accountant, 30 audit assignments whether in respect of private Companies or other Companies, with the exception of one person Companies and dormant companies.

   (b) in the case of Chartered Accountants in practice, 30 audit assignments per partner in the firm, whether in respect of private Companies or other Companies, with the exception of One person Companies and dormant companies[2].

2. In computing the "specified number of audit assignments"-

   (a) the number of audit of such Companies, which he or any partner of his firm has accepted whether singly or in combination with any other Chartered Accountant in practice or firm of such Chartered Accountants, shall be taken into account.

[2] As incorporated pursuant to decision of Council at its 388th Meeting held on 6th and 7th Feb., 2020.

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(b) the audit of the head office and branch offices of a Company by one Chartered Accountant or firm of such Chartered Accountants in practice shall be regarded as one audit assignment.

(c) the audit of one or more branches of the same Company by one Chartered Accountant in practice or by firm of Chartered Accountants in practice in which he is a partner shall be construed as one audit assignment only.

(d) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.

A Chartered Accountant in practice, whether in full-time or part time employment elsewhere, shall not be counted for the purpose of determination of "specified number of audit of Companies" by firms of Chartered Accountants.

A Chartered Accountant being a part time practicing partner of a firm shall not be taken into account for the purpose of reckoning the audit assignments of the firm.

A Chartered Accountant in practice as well as firm of Chartered Accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of Chartered Accountants, or by any of the partners of the firm in his individual name or as a partner of any other firm, as far as possible in the prescribed format.

Chapter IX

Appointment as Statutory auditor

A member of the Institute in practice shall not accept the appointment as statutory auditor of Public Sector Undertaking(s)/ Government Company(ies)/Listed Company(ies) and other Public Company(ies) having turnover of ₹ 50 crores or more in a year where he accepts any other work(s) or assignment(s) or service(s) in regard to the same Undertaking(s)/ Company(ies) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same Undertaking/company.

Provided that in case appointing authority(ies)/regulatory body(ies) specify(ies) more stringent condition(s)/restriction(s), the same shall apply instead of the conditions/restrictions specified under these Guidelines.

The above restrictions shall apply in respect of fees for other work(s) or service(s) or assignment(s) payable to the statutory auditors and their associate concern(s) put together.

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For the above purpose,

(i) the term "other work(s)" or "service(s)" or "assignment(s)" shall include Management Consultancy and all other professional services permitted by the Council pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 but shall not include:-

(a) audit under any other statute;

(b) certification work required to be done by the statutory auditors; and

(c) any representation before an authority;

(ii) the term "associate concern" means any corporate body or partnership firm which renders the Management Consultancy and all other professional services permitted by the Council wherein the proprietor and/or partner(s) of the statutory auditor firm and/or their "relative(s)" is/are Director/s or partner/s and/or jointly or severally hold "substantial interest" in the said corporate body or partnership;

(iii) the terms "relative" and "substantial interest" shall have the same meaning as are assigned thereto under Appendix (9) to the Chartered Accountants Regulations, 1988.

In regard to taking up other work(s) or service(s) or assignment(s) of the undertaking/company referred to above, it shall be open to such associate concern or corporate body to render such work(s) or service(s) or assignment(s) so long as aggregate remuneration for such other work(s) or service(s) or assignment(s) payable to the statutory auditor/s together with fees payable to its associate concern(s) or corporate body(ies) do/does not exceed the aggregate of fee payable for carrying out the statutory audit.

Illustration 39

A is the auditor of Z Ltd., which has a turnover of ₹ 200 crore. The audit fee for the year is fixed at ₹ 50 lakhs. During the year, the company offers A an assignment of management consultancy within the meaning of Section 2(2)(iv) of the CA Act, 1949 for a remuneration of ₹ 1 crore. A seeks your advice on accepting the assignment.

Appointment as a Statutory Auditor of a PSUs'/Govt Company(ies)/Listed Company(ies) and Other Public Company(ies): As per the Council General Guidelines 2008, under Chapter IX on appointment as statutory auditor a member of the Institute in practice shall not accepts the appointment as a statutory auditor of a PSUs'/Govt company(ies)/Listed company(ies) and other public company(ies) having a turnover of ₹ 50 crores or more in a year and where he accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the

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same undertaking. For this purpose, the other work/services include Management Consultancy and all other professional services permitted by Council excluding audit under any other statute, Certification work required to be done by the statutory auditor and any representation before an authority.

Conclusion: In view of the above provision, it would be a misconduct on A's part if he accepts the management consultancy assignment for a fee of ₹ 1 crore.

Chapter X
Appointment of an auditor when he is indebted to a concern

A member of the Institute in practice or a partner of a firm in practice or a firm or a relative of such member or partner shall not accept appointment as auditor of a concern while indebted to the concern or given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding ₹ 100,000/-.

Illustration 40

D, who conducts the tax audit u/s 44AB of the Income Tax Act, 1961 of M/s ABC, a partnership firm, has received the audit fees of ₹ 2,50,000 on progressive basis in respect of the tax audit for the year ended 31.3.2024. The audit report was, however, signed on 25.5.2024.

Entire Audit Fees Received in Advance: As per Chapter X of Council General Guidelines, 2008 a member of the Institute in practice or a partner of a firm in practice or a firm shall not accept appointment as auditor of a concern while indebted to the concern or given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding ₹ 1,00,000/-.

However, the Research Committee of the ICAI has expressed the opinion that where in accordance with the terms of engagement of auditor by a client, the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job, he cannot be said to be indebted to the company at any stage.

Conclusion: In the instant case, Mr. D is appointed to conduct a tax audit u/s 44AB of the Income Tax Act, 1961. He has received the audit fees of ₹ 2,50,000 in respect of the tax audit for the year ended 31.3.2024 which is on a progressive basis. Therefore, Mr. D will not be held guilty for misconduct.

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Chapter XI
Directions in case of unjustified removal of auditors

A member of the Institute in practice shall follow the direction given, by the Council or an appropriate Committee or on behalf of any of them, to him being the incoming auditor(s) not to accept the appointment as auditor(s), in the case of unjustified removal of the earlier auditor(s).

Chapter XIII
Guidelines on Tenders

A member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for chartered accountants, such as audit and attestation services. However, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.

Chapter XIV
Unique Document Identification Number (UDIN) Guidelines

Whereas, to curb the malpractice of false certification/attestation by the unauthorized persons & to eradicate the practice of bogus certificates and to save various regulators, banks, stakeholders etc. from being misled, the Council of the Institute decided to implement an innovative concept to generate Unique Document Identification Number (UDIN) mandatorily for all kinds of the certificates/GST and Tax Audit Reports and other attest function in phased manner, for which members of the ICAI were notified through the various announcements published on the website of ICAI www.icai.org at the relevant times.

A member of the Institute in practice shall generate Unique Document Identification Number (UDIN) for all kinds of the certification, GST and Tax Audit Reports and other Audit, Assurance and Attestation functions undertaken/signed by him which made mandatory from the following dates through announcements published on the website of the ICAI www.icai.org at the relevant time: -

- For all Certificates w.e.f. 1st February, 2019.
- For all GST and Tax Audit Reports w.e.f. 1st April, 2019.
- For all other Audit, Assurance and Attestation functions w.e.f. 1st July, 2019.

Chapter XV
Guidelines for Networking

Concept: To enhance their ability to provide professional services, firms frequently form larger structures with other firms and entities. Whether these larger structures create a network depends

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on the particular facts and circumstances and does not depend on whether the firms and entities are legally separate and distinct.

For example, a larger structure may be aimed only at facilitating the referral of work, which in itself does not meet the criteria necessary to constitute a network. Alternatively, a larger structure might be such that it is aimed at co-operation and the firms share a common brand name, a common system of quality control, or significant professional resources and consequently is deemed to be a network.

The judgment as to whether the larger structure is a network shall be made in light of whether a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that the entities are associated in such a way that a network exists. This judgment shall be applied consistently throughout the network.

Where the larger structure is aimed at co-operation and it is clearly aimed at profit or cost sharing among the entities within the structure, it is deemed to be a network. However, the sharing of immaterial costs does not in itself create a network. In addition, if the sharing of costs is limited only to those costs related to the development of audit methodologies, manuals, or training courses, this would not in itself create a network. Further, an association between a firm and an otherwise unrelated entity to jointly provide a service or develop a product does not in itself create a network.

Where the larger structure is aimed at cooperation and the entities within the structure share common ownership, control or management, it is deemed to be a network. This could be achieved by contract or other means.

Where the larger structure is aimed at co-operation and the entities within the structure share common quality control policies and procedures, it is deemed to be a network. For this purpose, common quality control policies and procedures are those designed, implemented and monitored across the larger structure.

Where the larger structure is aimed at co-operation and the entities within the structure share a common business strategy, it is deemed to be a network. Sharing a common business strategy involves an agreement by the entities to achieve common strategic objectives. An entity is not deemed to be a network firm merely because it co- operates with another entity solely to respond jointly to a request for a proposal for the provision.

Where the larger structure is aimed at co-operation and the entities within the structure share the use of a common brand name, it is deemed to be a network. A common brand name includes common initials or a common name. A firm is deemed to be using a common brand name if it

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includes, for example, the common brand name as part of, or along with, its firm name, when a partner of the firm signs an audit report.

Even though a firm does not belong to a network and does not use a common brand name as part of its firm name, it may give the appearance that it belongs to a network if it makes reference in its stationery or promotional materials to being a member of an association of firms. Accordingly, if care is not taken in how a firm describes such memberships, a perception may be created that the firm belongs to a network.

Where the larger structure is aimed at co-operation and the entities within the structure share a significant part of professional resources, it is deemed to be a network. **Professional resources include:**

- Common systems that enable firms to exchange information such as client data, billing and time records;
- Partners and staff;
- Technical departments that consult on technical or industry specific issues, transactions or events for assurance engagements;
- Audit methodology or audit manuals; and
- Training courses and facilities.

The determination of whether the professional resources shared are significant, and therefore the firms are network firms, shall be made based on the relevant facts and circumstances. Where the shared resources are limited to common audit methodology or audit manuals, with no exchange of personnel or client or market information, it is unlikely that the shared resources would be significant. The same applies to a common training endeavor. Where, however, the shared resources involve the exchange of people or information, such as where staff are drawn from a shared pool, or a common technical department is created within the larger structure to provide participating firms with technical advice that the firms are required to follow, a reasonable and informed third party is more likely to conclude that the shared resources are significant.

Forms of the Network :

The different forms of Network can be as under:-

A network can be constituted as a mutual entity which will act as a facilitator for the constituents of the Network. In such a case the Network itself will not carry out any professional practice.

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A network can be constituted as a partnership firm subject to the condition that the total number of partners does not exceed twenty.

A network can be constituted as a Limited Liability Partnership subject to the provision of the Chartered Accountant Act and Rules and such other laws as may be applicable.

A network can be constituted as company subject to the guidelines prescribed by Institute for corporate form of practice and formation of management consultancy services company.

Network Firms shall consist of sole Practitioner/proprietor, partnership or any such entity of professional accountants as may be permitted by the Act.

A firm is allowed to join only one network.

Firms having common partners shall join only one Network.

Approval of Name of Network amongst firms registered with Institute:

1. The Network may have distinct name which should be approved by the Institute. To distinguish a "Network" from a "firm" of Chartered Accountants, the words "& Affiliates" shall be used after the name of the network and the words "& Co." / "& Associates" shall not be used. The prescribed format of application for approval of Name for Network is at Form 'A' (enclosed). The names of the network may be as mentioned in Appendix II.

2. Provisions of Regulation 190 of the Chartered Accountants Regulations, 1988 shall be applicable to the name of Network. However, even if a name is approved and subsequently it is found that the same is undesirable then, the said name may be withdrawn at any time by the Institute. The Institute shall reject any undesirable name and the provisions in respect of names of companies as prescribed in the Companies Act, 1956 shall be applicable in spirit.

3. The Institute shall approve or reject the name of the Network and intimate the same to the Network at its address mentioned in Form 'A' within a period which shall not be later than 30 days from the date of receipt of the said Form.

4. Mere approval of the name of the Network shall not entitle the Network to carry on practice in its own name.

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Registration of Network with entities in India

1. **After the name of a Network is approved as per provision under Guideline 5, the Institute same shall reserve such name for a period of three (3) months from the date of approval.**
2. **The Network shall get itself registered with the Institute by applying in Form B within the period of 3 months, failing which the name assigned shall stand cancelled on the expiry of the said period.**
3. **Registration of Network with Institute is mandatory.**
4. **If different Indian firms are networked with a common Multinational Accounting Firm, they shall be considered as a part of network.**

Listing of Network with entities outside India

1. **The duly authorized representative(s) of the Indian Member firm (s)/Member constituting the Network with entities outside India shall file a declaration with the Institute in Form `D' for Listing of such Network within 30 days from the date of entering into the Network arrangement.**
2. **Proprietary/individual members, partnership firms as well as members in LLP or any such other entity of members as may be permitted by the Act, shall be permitted to join such network with entities outside India provided that the proprietary/individual members, partnership firms as well as members in LLP or any such other entity of members are allowed to join only one network and firms having common partners shall join only one such network.**

Change in constitution of registered Network:

In case of change in the constitution of registered Network on account of any entry into or exit from the Network, the network shall communicate the same to the Institute by filing Form 'C' within a period of thirty (30) days from the date of change in the constitution.

Ethical Compliance:

Once the relationship of network arises, it will be necessary for such a network to comply with all applicable ethical requirements prescribed by the Institute from time to time in general and the following requirements in particular: -

1. If one firm of the network is the statutory auditor of an entity then the associate [including the networked firm(s)] or the said firm directly/indirectly shall not accept the internal audit

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or book-keeping or such other professional assignments which are prohibited for the statutory auditor firm.

2. The guidelines of ceiling on Non-audit fees is applicable in relation to a Network as follows: -

   i) For a Network firm who is doing statutory audit (including its associate concern and/or firm(s) having common partnership), it shall be the same as mentioned in the said notification; and

   ii) For other firms of the same Network collectively, it shall be 3 times of the fee payable for carrying out the statutory audit of the same undertaking/ company.

3. In those cases where rotation of firms is prescribed by any regulatory authority, no member firm of the network can accept appointment as an auditor in place of any member firm of the network which is retiring.

4. The Network may advertise the Network to the extent permitted by the Advertisement Guidelines issued by Institute. The firms constituting the network are permitted to use the words "Network Firms" on their professional stationery.

5. The constituent member firms of a Network and the Network shall comply with all the Ethical Standards prescribed by the Council from time to time.

Consent of Client:

The effect of registration of network with Institute will be deemed to be a public notice of the network and therefore consent of client will be deemed to be obtained.

Framework of Internal Byelaws of Network:

To streamline the networking, a network shall formulate operational bye-laws. Bye-laws may contain the following clauses on which the affiliates of the network may enter into a written agreement among themselves:

(i) Appointment of a Managing Committee, from among the managing partners of the member firms of the network and the terms and conditions under which it should function. The minimum and maximum number of members of the Managing Committee shall also be agreed upon.

(ii) Administration of the network.

(iii) Contribution of membership fees to meet the cost of the administration of the network.

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(iv) Identifying a partner of any of the member firms of the network to be responsible for the assignment (engagement partner).

(v) Dispute settlement procedures through arbitration and conciliation.

(vi) Development of training materials for members of the network.

(vii) Issue of News-letters for staff and clients.

(viii) Development of software for different types of assignments.

(ix) Development and maintenance of data bases relevant for different types of assignments.

(x) Library.

(xi) Appointment of a technical director to whom references can be made.

(xii) Determining the methodology for drawing resources from each member firm.

(xiii) Determining compensation to member firms for resources to be drawn from them.

(xiv) Peer review of the member firms.

These clauses are illustrative.



9. Illustrative examples of names of Network: -

(a) If the Network is a Mutual Entity or Partnership Firm:

AB & Affiliates

(b) If the Network is a LLP:

AB Affiliates LLP

(c) If the Network is a Limited Company:

AB Affiliates P. Ltd/Limited

Chapter XVI

Logo Guidelines

Guidelines issued in 2023 for using the new CA India logo for CA members prescribes that the logo consists of the letters 'CA' in blue colour with a tri colour tick mark (upside down) with white background. The blue colour not only stands out on any background but also denotes creativity, innovativeness, knowledge, integrity, trust, truth, stability, and depth. The upside-down tick mark, typically used by Chartered Accountants, has been included to symbolise the wisdom and value of the professional.

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'India' is also added in the logo, as it epitomizes the Institute's connection to India First approach and commitment to the serve the Indian economy in public interest.

- *There should be no alteration of the font (colour, bold/unbold, size). Moreover, there should be no change in spacing and dimensions.*
- *The colour palette is*

#F37920
C0 M62 Y91 K0

#145886
C93 M61 Y24 K9

#55B848
C67 M0 Y88 K0

- *Do not change the design and colours including the white background.*
- *Refrain from rotating or tilting the logo clockwise and anti-clockwise.*
- *The logo should not be shrunk or distorted changing the original proportion.*

Note: While members are encouraged to use the new CA India Logo as published on letterheads, visiting cards, website etc, a transition time of one year has been provided to use existing stationary/signage replacement etc.



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Chapter XVII

Guidelines for Corporate Form of Practice

The Council decided to allow members in practice to hold the office of Managing Director, Whole-time Director or Manager of a body corporate within the meaning of the Companies Act provided that the body corporate is engaged exclusively in rendering Management Consultancy and Other Services permitted by the Council in pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 and complies with the conditions(s) as specified by the Council from time to time in this regard.

The members can retain full time Certificate of Practice besides being the Managing Director, Whole-time Director or Manager of such Management Consultancy Company. There will be no restriction on the quantum of the equity holding of the members, either individually and/ or along with the relatives, in such Company. Such members shall be regarded as being in full- time practice and therefore can continue to do attest function either in individual capacity or in Proprietorship/Partnership firm in which capacity they practice and wherein they are also entitled to train articled/audit assistants.

The name of the Management Consultancy Company is required to be approved by the Institute and such Company has to be registered with the Institute. The guidelines alongwith the prescribed application forms for approval of name and registration, provisions of ethical compliance and other details have been issued and the same will come into force w.e.f. 1.10.2006.

On abundant caution, it may be clarified that no audit practice can be done in Corporate Form. The consultancy practice hitherto done in Individual or Firm Status alone is now intended to be permitted in Corporate Form also.

Ethical Compliance: (i) Once the Management Consultancy Company is Registered with the Institute as per the Guidelines, it will be necessary for such a Company to comply with the following requirements: -

(a) If the individual practitioner/sole-proprietorship firm/partnership firm is the statutory auditor of an entity then the Management Consultancy Company should not accept the internal audit or book-keeping or such other professional assignments, which are prohibited for the statutory auditor firm.

(b) The Notification No. 1-CA(7)/60/2002 dated 8th March, 2002 (enclosed) in respect of ceiling on Non-audit fees is applicable in relation to a Management Consultancy Company.

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(c) The Management Consultancy Company shall comply with clauses (6) & (7) of Part-I of the First Schedule to the Chartered Accountants Act, 1949 and such other directives as may be issued by the Institute from time to time.

(ii) The Management Consultancy Company shall give an undertaking that it shall comply with clauses (6) & (7) of Part-I of the First Schedule to the Chartered Accountants Act, 1949 and such other directives as may be issued by the Institute from time to time.

Object of Management Consultancy Company: The Management Consultancy Company shall engage itself only in Management Consultancy & Other Services. The Management Consultancy Company shall give an undertaking that it shall render only Management Consultancy & Other Services prescribed by the Council pursuant to powers under section 2 (2)(iv) of the Chartered Accountants Act, 1949.

Note: Students are advised to refer Appendix 'D' of the Code for more details.

9.1 Council Guidelines for Advertisement, 2008

1. Write up -

The Members may advertise through a write up setting out their particulars or of their firms and services provided by them subject to the following Guidelines and must be presented in such a manner as to maintain the profession's good reputation, dignity and its ability to serve the public interest.

The Member(s)/Firm(s) should ensure that the contents of the Write up are true to the best of their knowledge and belief and are in conformity with these Guidelines and be aware that the Institute of Chartered Accountants of India will neither approve a propose write-up, nor owns any responsibility whatsoever for such contents or claims by the writer Member(s)/ Firm(s).

The write-up shall comply with the following conditions:-

A. It shall be honest and truthful.

B. There shall be no exaggerated claims for the services offered by the member or the Firm, or the qualifications or experience of the member or any of the partners or any other person associated with the Firm.

C. It must not make any disparaging references or unsubstantiated comparisons to the work of others.

D. It should not be of a nature that may bring the profession into disrepute.

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E. It should not contain testimonials or endorsements concerning Member(s) or names of clients (both the past and present) or the fees charged.

F. It should not contain any information about achievements /awards (except the awards given by the Central or State Governments or Regulatory bodies) or any other position held, or accreditation(s) granted by any organisation.

G. Monogram of any kind or use of any kind of catch words is not permissible.

H. The Membership No./FRN (as may be applicable) is mandatory to be mentioned in the write-up.

I. It should not be of font size exceeding 14.

J. It must not be violative of any provisions of the Chartered Accountants Act, 1949, the Chartered Accountants Regulations, 1988, Code of Ethics, 2020 or any Guideline of the Council

The Institute of Chartered Accountants of India may issue a reasoned directive for removal or withdrawal of the whole write-up or of any part(s) thereof.

2. Advertisement through write-up

While advertising the services or details of Firms, the write-up may include only the following information:

(A) For Members

(i) CA……..Name

(ii) Membership No. with Institute

(iii) Age

(iv) Date of becoming ACA

(v) Date of becoming FCA

(vi) Date from which COP held

(vii) Recognized qualifications

(viii) Languages known

(ix) Telephone/Mobile/Fax No.

(x) Professional Address

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(xi) Website

(xii) E-mail

(xiii) CA Logo

(xiv) Passport *style*[3] photograph

(xv) Details of Employees (Nos. -)

(a) Chartered Accountants -

(b) Other Professionals –

(c) Articles/Audit Assistants

(d) Other Employees

(xvi) Names of the employees and their particulars on the lines allowed for a member as stated above.

(xvii) Services provided

(a) .....

(b) .....

(c) .....

(xviii) Position held as Director or Managing Director in a Management Consultancy Company registered with the Institute[4].

(B) For Firms

(i) Name of the Firm ..... Chartered Accountants

(ii) Firm Registration No. with Institute

(iii) Year of establishment.

(iv) Professional Address(s) registered with the Institute (both Head Office and Branches)

(v) Working Hours

(vi) Tel. No(s)/Mobile No./Fax No(s)

3 As ameanded by Council at its 388th Meeting held on 6th and 7th Feb., 2020.

4 As incorporated pursuant to decision of Council at its 388th Meeting held on 6th and 7th Feb., 2020.

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(vii) E-mail

(viii) No. of partners

(ix) Name of the proprietor/partners and their particulars on the lines allowed for a member as stated above including passport *style*[5] photograph.

(x) CA Logo

(xi) Details of Employees (Nos. -)

(a) Chartered Accountants -

(b) Other professionals –

(c) Articles/Audit Assistants

(d) Other employees

(xii) Names of the employees of the firm and their particulars on the lines allowed for a member as stated above.

(xiii) Services provided:

(a) .....

(b) .....

(c) .....

(xiv) Affiliation with a Network registered with the Institute[6]

The write-up may have the Signature, Name of the Member/ Name of the Partner signing on behalf of the firm, Place and Date.

3. Website of the CA Firms[7]

The Council has approved the detailed guidelines for posting the particulars on Website by Chartered Accountant(s) in practice and firm(s) of Chartered Accountants in practice :-

1. The Chartered Accountants and/or Chartered Accountants' Firms would be free to create their own Website. The following stipulations will be applicable on such websites:-

[5] As amended by Council at its 388th Meeting held on 6th and 7th Feb., 2020.

[6] As incorporated pursuant to decision of Council at its 388th Meeting held on 6th and 7th Feb. 2020.

[7] As amended and included under Guidelines for Advertisement pursuant to decision of Council at its 388th Meeting held on 6th and 7th Feb., 2020.

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2. The actual format of the Website is not being prescribed nor any standard format of the Website is being given to provide independence to the Members.

3. The Chartered Accountants and/or Chartered Accountants' Firms would ensure that their Websites are run on a "pull" model and not a "push" model of the technology to ensure that any person who wishes to locate the Chartered Accountants or Chartered Accountants' firms would only have access to the information and the information should be provided only on the basis of specific "pull" request.

4. The Chartered Accountants and/or Chartered Accountants' Firms should ensure that none of the information contained in the Website be circulated on their own or through E-mail or by any other mode or technique except on a specific "pull" request.

5. The Chartered Accountants would also not issue any circular or any other advertisement or any other material of any kind whatsoever by virtue of which they solicit people to visit their Website. The Chartered Accountants would, however, be permitted to mention their Website address on their professional stationery and email.

6. The following information may be allowed to be displayed on the Firms/Members' Websites:

   (i) Member/Trade/Firm name.

   (ii) Year of establishment.

   (iii) Member/Firm's Address (both Head Office and Branches)

   Tel. No(s)

   Fax No(s)

   E-mail ID(s)

   (iv) Nature of services rendered (to be displayable only on specific "pull" request)

   (v) Partners

Partners Name	Year of Qualification	Other Qualification(s)	Tel.. Off.- Direct Res. Mobile E-mail address	Area of Experience (to be displayable only on specific "pull" request)

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(vi) Details of Employees -

Professional	Others	Name	Designation	Area of experience (to be displayable only on specific "pull" request)

(vii) Job vacancies for the Chartered Accountant/firm of Chartered Accountants (including articleship).

(viii) No. of articled assistants. (to be displayable only on specific "pull" request).

(ix) Nature of assignments handled (to be displayable only on specific "pull" request). Names of clients and fee charged cannot be given. While the mention of names of clients is not permissible, members may take note of the following with regard to website of the Firm:-

Note: Disclosure of names of clients and/or fees charged, on the website is permissible only where it is required by a regulator, whether or not constituted under a statute, in India or outside India, provided that such disclosure is only to the extent of requirement of the regulator and is made only till such period that the member works under the purview of such Regulator/ such requirements of the Regulator are in force. Where such disclosure of names of clients and/or fees charged is made on the website, the member/ firm shall ensure that it is mentioned on the website [in italics], below such disclosure itself, that "This disclosure is in terms of the requirement of [name of the regulator] having jurisdiction in [name of the country/ area where such regulator has jurisdiction] vide [Rule/ Directive etc. under which the disclosure is required by the Regulator].

7. Display of Passport style photograph is permitted.

8. The members may include articles, professional information, bulletin boards, professional updation and other matters of larger importance or of professional interest on the website. Educational videos on topics of professional relevance are permissible.

9. The chat rooms can be provided which permit chatting amongst members of the ICAI and between Firms and its clients. The confidentiality protocol would have to be observed. The Firms can provide document management facility with distinct log in and password facility to the clients to access copies of their documents on the Firm website.

10. The Firm can provide link of its page on Social Networking site. However, the members should not solicit people to visit or like their respective page(s) on such social Networking site.

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11. The members/firms can provide on line advice to their clients who specifically request for the advice whether free of charge or on payment.

12. The details in the Website should be so designed that it does not amount to soliciting client or professional work. In case any content or technical feature of Website is against the professional Code of Conduct and Ethics as well as the restrictions contained in the schedules to the Chartered Accountants Act, 1949 or against the guidelines or directions issued by ICAI from time to time, appropriate action will be initiated by the ICAI in terms of its disciplinary mechanism either suo moto or on complaint as provided under the Chartered Accountants Act, 1949.

13. The Website should ensure adequate secrecy of the matters of the clients handled through Website.

14. No Advertisement in the nature of banner or any other nature will be permitted on the Website.

15. The Website should be befitting the profession of Chartered Accountants and should not contain any information or material which is unbecoming of a Chartered Accountant.

16. The Website may provide a link to the Website of ICAI, its Regional Councils and Branches and also the Website of Govt./Govt. Departments/Regulatory authorities/other Professional Bodies.

17. The Website address should be as near as possible to the individual name/trade name, firm name of the Chartered Accountant in practice or firm of Chartered Accountants in practice. But it should not amount to soliciting clients or professional work or advertisement of professional attainments or services. The Ethical Standards Board (ESB) of ICAI will decide in case there is any difficulty.

18. The Website should mention the information which is not at material variance from the information as per the ICAI's records.

4. Online Third Party Platforms

A number of non-Chartered Accountants' firms, corporates including banks, finance Companies and newspapers have set up their own Websites providing advisory services on taxation and other areas where Chartered Accountants are rendering professional service. Some of such Websites may request Chartered Accountants or Chartered Accountants' firms to provide consultation and advice through their Websites. No other service, besides consultancy and advice can be rendered through such websites, This would be permitted subject to the condition that on the Website, contact address of the Chartered Accountant concerned is not provided nor such Website will contain any material

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which advertises professional achievements or status of such Chartered Accountant except making a statement that they are Chartered Accountants. The name of Chartered Accountants' firm with suffix "Chartered Accountants" would not be permitted.

5. Publication of Name or Firm Name by Chartered Accountants in the Telephone or other Directories published by Telephone Authorities or Private Bodies

The Chartered Accountants and Chartered Accountants Firms may have entries made in a Telephone Directory (in printed and electronic form) either by making a special request or by means of an additional payment. The Council has also considered the question of permitting entries in respect of Chartered Accountants and their firms under specified groups in telephone/trade directories subject to the following additional restrictions :-

(i) The entry should not appear in any other section/category except that of 'Chartered Accountants'.

(ii) The member/firm should belong to the town/city in respect of which the directory is being published.

(iii) The order of the entries should not be in any manner other than alphabetical.

(iv) The entry should not be made in a differential or prominent manner giving the impression of publicity/advertisement.

(v) The entries should not be restricted and should be open to all the Chartered Accountants/firms of Chartered Accountants in the particular city/town in respect whereof the directory is published.

(vi) The members can also include their names in trade/ social directories.

6. Application based Service provider Aggregators

It is not permissible for members to list themselves with online Application based service provider Aggregators, wherein other categories like businessmen, technicians, maintenance workers, event organizers etc. are also listed.

7. Specialised Directories for limited circulation

The name, description and address of member (or firm) may appear in any directory or list of members of a particular body in which the names are listed alphabetically. For a specialised directory or a publication such as a "Who's Who" (including those compiled on purely local basis), a member should use his discretion in supplying information, bearing in mind the nature and purpose of the

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publications. In addition to his name, description and address and those of his firm, a member may give where appropriate, directorships held and reasonable personal details and may state his outside interests. He should not, however, give the names of any of his clients.

8. Exemptions

1 A special exemption has been made as regards publication of the name and address of a member or that of his firm, with the description Chartered Accountant(s), in an advertisement appearing in the press in the following circumstances, provided that the advertisement is not displayed more prominently than is usual for such advertisements or the name of the member or that of his firm with the designation Chartered Accountant(s) appears in type not bolder than the substance of the advertisement:-

(a) Advertisement for recruiting staff in the member's own office.

(b) Advertisement inserted on behalf of clients requiring staff or wishing to acquire or dispose of business or property.

(c) Advertisement for the sale of a business or property by a member acting in a professional capacity as trustee, liquidator or receiver.

2 When advertising for staff, it is desirable that members should avoid the expression such as "a well-known firm", since this would savour of advertisement. Similar considerations apply to advertisements for articled assistants. The advertisements should not contain any promotional element nor should there be any suggestion that the services offered by the Chartered Accountant or his firm are superior to those offered by other accountants.

10 RECOMMENDED SELF-REGULATORY MEASURES

As the members are aware, the Council has decided upon certain self-regulatory measures in order to ensure a healthy growth of the profession and an equitable flow of professional work among the members. These measures are reviewed from time to time and are published in the Journal of the Institute for observance by the members. The self-regulatory measures are recommendatory. However, considering the spirit underlying these measures, the Council expects that each and every member will effectively implement them. The Council earnestly believes that implementation of these measures would go a long way in ensuring equitable flow of work among the members and would also further enhance the prestige of the profession in the society.

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The more important of these recommendations are as under:

10.1 Branch Audits

The branch audits of a company should not be conducted by its statutory auditors consisting of ten or more members, but should be conducted by the local firms of auditors consisting of less than ten members. This should not be understood to mean any restriction on the right of the statutory auditors to have access over branch accounts conferred under the Companies Act, 2013. This restriction may not apply in the following cases.

(i) where the accounting records of the branches are maintained at the head office of the respective companies, and

(ii) where significant operations of an undertaking or a company are carried out at its branch office.

10.2 Joint Audit

In the case of large companies, the practice of associating a practicing firm with less than five members as Joint auditors should be encouraged. Where a client desires to appoint such a firm as joint auditor, the senior firm should not object to the same.

10.3 Ratio Between Qualified and Unqualified Staff

In the Council's view, a practicing firm of Chartered Accountants engaged in audit work should have at least one member for every five non-qualified members of the staff, excluding articled and audit assistants, typists, peons and other persons not engaged directly in such professional work.

10.4 Disclosure of Interest by Auditors in other Firms

The Council has decided that as a good and healthy practice, auditors should make a disclosure of the payments received by them for other services through the medium of a different firm or firms in which the said auditor may be either a partner or proprietor.

10.5 *Recommended Minimum Scale of Fees

The Institute has issued revised Minimum scale of Fees for the professional assignments of the members of ICAI. The recommended scale of Fees is to be charged as per the work performed for various professional assignments. The Fees has been recommended separately for Class-A, B and C cities.

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10.5.1 Fees - Relative Size:

Differentiated disclosure requirements for non public interest entities and public interest entities are following:-

1. **For non Public Interest Entities (PIE)-**Disclosure is required where for two consecutive years, the gross annual professional fees from an audit client represent more than 40% of the total fees of the firm.

2. **For public interest entities-** Disclosure is required where for two consecutive years, the gross annual professional fees from an audit client represent more than 20% of the total fees of the firm.

Exemption from applicability of the above provision will be in case where total Fees received by Firm does not exceed 20 lacs of rupees.

In addition, exemption from applicability of the above provision is also given in the case of audit of government Companies, public undertakings, nationalised banks, public financial institutions, regulators or where appointments of auditors are made by the Government.

Case Scenario

Synopsis: The case scenario underscores ethical and quality requirements to be complied with by statutory auditor of a listed company. Failure to perform audit of financial statements in accordance with Standards on Auditing can result in breakdown of trust of investors and public at large. The case involves issue of non-adherence to requirements of *SA 501, SA 550 and SA 505* by statutory auditor of a listed company.

Only major lapses have been considered for developing this case scenario for the sake of brevity.

The case scenario is presented in the following manner: -

I. Relevant provisions of the Companies Act, 2013 and requirements of relevant Standards on Auditing

II. Relevant Clauses of Part I of Second Schedule to Chartered Accountants Act, 1949

III. Facts of the case

IV. Major lapses pointed out by NFRA, engagement partner's submissions and NFRA's contentions/findings

V. Conclusion including its basis

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I. Relevant provisions of the Companies Act, 2013 and requirements of relevant Standards on Auditing

[1] Section 132(4) of the Companies Act, 2013

NFRA has power to investigate into matters of professional or other misconduct committed by any member or firm of chartered accountants registered under Chartered Accountants Act, 1949 for certain classes of bodies corporate. By virtue of this section, it has also got power to impose penalty on erring members and debarring members of firm from undertaking audit work.

[2] Relevant requirements of Standards on Auditing

- SA 501 requires that when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attendance at physical inventory counting *unless impracticable*.

  It further requires that if attendance at physical inventory counting is *impracticable,* the auditor shall perform *alternative audit procedures* to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall *modify the opinion* in the auditor's report in accordance with SA 705.

- SA 550 requires auditor to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately *identified, accounted for and disclosed in the financial statements* in accordance with the applicable financial reporting framework.

- SA 505 requires that in case management refuses to allow the auditor to send a confirmation request, reasons adduced by management need to be inquired and audit evidence has to be sought for as to validity and reasonableness of reasons. Further, implications of such refusal on risks of material misstatement *including risk of fraud* and on nature, timing and extent of other audit procedures are to be evaluated.

  It further requires auditor to perform *alternative audit procedures* designed to obtain relevant and reliable audit evidence.

II. Relevant clauses of Part I of Second Schedule to Chartered Accountants Act, 1949

- Under clause 7 of Part I of Second Schedule to Chartered Accountants Act, 1949, a chartered accountant in practice shall be deemed to be guilty of professional misconduct,

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if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

- Under clause 8 of Part I of Second Schedule to Chartered Accountants Act, 1949, a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion
- Under clause 9 of Part I of Second Schedule to Chartered Accountants Act, 1949, a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

III. Facts of the case

NFRA initiated action u/s 132(4) of the Companies Act, 2013 for investigating into professional misconduct of engagement partner of an audit firm pursuant to information received from ROC, Mumbai regarding investigation conducted by Regional Director into affairs of WNLL, listed on SME segment of BSE. The key financial data for company for financial year 2016-17 was as under: -

Particulars	Amount (in ₹ crores)
Revenue from Operations	51.77
PBT	1.44
Inventory	20.60
Trade receivables	14.93
Trade payables	13.78

The engagement partner had issued an unmodified opinion for financial year 2016-17. The engagement partner was requested on 18.02.2022 to submit audit file and SQC1 policy of firm which was submitted by him vide email dated 18.03.2022. Subsequently, a show-cause notice was issued to engagement partner charging him with professional misconduct for failure to perform his duties as engagement partner.

IV. Major lapses pointed out by NFRA, engagement partner's submissions and NFRA's contentions/findings

[1] Failure to obtain audit evidence regarding existence and condition of inventory

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The EP was charged with failure to obtain sufficient appropriate audit evidence regarding existence and condition of inventory by not attending physical inventory counting in accordance with SA 501.

	EP's submissions	*NFRA's contentions/findings*
1.	The appointment as statutory auditor was made on 18.4.2017. Therefore, it was not possible to attend physical verification of inventories as on 31.3.2017.	SA 501 requires if attendance at physical inventory count is ***impracticable***, ***alternative audit procedures*** shall be performed to obtain sufficient appropriate audit evidence regarding existence and condition of inventories. If it is not possible to so, the auditor shall ***modify*** opinion in accordance with SA 705. There was no documentation in audit file of audit procedures having been performed in this respect. Reliance was also placed on decision of PCAOB, US regulator in a similar case.
2.	Inventory holding level was in accordance with past trends. Stock records were cross verified in respect of selected items and reconciled with entries of receipts and issue in books of accounts.	There was no documentation in audit file of audit procedures having been performed in this respect.

[2] Failure to identify related party and related party transactions

The EP was charged with failure to identify related parties and transactions with them. The company made almost 100% of sales to a related party which was not identified as such in annual report of the company for FY 2016-17.

	EP's submissions	*NFRA's contentions/findings*
1.	It was tried to be ascertained from management regarding existence of related parties and previous audit reports were also relied upon in this regard.	The related party to whom 100% of sales was made was previously identified as related party in financial statements for FY 2013-14. Since almost 100% of sales were to this party, EP should have applied ***professional skepticism*** to probe further into antecedents of the party. There is no evidence in audit file regarding this. Reliance was also placed on similar decision of PCAOB where it was held that auditor must evaluate whether related party transactions have been properly accounted for and disclosed in financial statements.

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[3] Failure to obtain external confirmations for Trade receivables and Trade payables

The EP was charged with gross negligence for not obtaining direct confirmations of balances from debtors and creditors and with failure to perform any alternative audit procedure in absence of confirmations from debtors and creditors in accordance with SA 505.

	EP's submissions	*NFRA's contentions/findings*
1.	The company management had denied contact details of parties due to fear of losing the business information. Further, all debtors and creditors were outstanding for less than 6 months.	It shows that management had imposed a ***limitation on scope*** of audit. Limitations imposed by management may have other implications for audit such as ***evaluation of fraud risks and continuance of engagement as per SA 705.*** No assessment of fraud risk having been evaluated is available in audit file and there is no evidence of additional procedures being performed by EP in absence of external confirmations. Reliance was also placed on PCAOB order in ***Satyam case*** in which failure during audit to obtain external confirmation of bank balances was highlighted.

V. Conclusion including its basis

The engagement partner did not comply with provisions of the Chartered Accountants Act, 1949 and showed gross negligence and lack of due diligence in performing statutory audit. He didn't ensure audit quality and was grossly negligent of professional duties by not adhering to requirements laid down in relevant Standards on Auditing as discussed above. It led to issuance of audit report that was not backed by valid audit evidence and was lacking in audit quality.

The engagement partner was held guilty of professional misconduct under clauses 7, 8 and 9 of Part I of Second Schedule to Chartered Accountants Act, 1949. He was also penalized and debarred for a period of two years from undertaking any audit of financial statements or internal audit of the functions and activities of any company or body corporate.

Key Takeaways

- A Chartered Accountant, *either in practice or in service*, has to abide by these ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their jobs.

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- Service users of professionals should be able to feel secure that there exists a framework of professional ethics which governs the provision of those services. Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants.
- A distinguishing feature of the accountancy profession is its acceptance of the responsibility to act in the public interest. Code of Ethics seeks to protect the interests of the profession as a whole. It is a shield that enables us to command respect.
- Part 1 of Code of ethics deals with requirements relating to complying with the Code, Fundamental Principles and Conceptual Framework, and is applicable to all professional accountants.
- The Code delineates integrity, objectivity, professional competence and due care, confidentiality and professional behaviour as fundamental principles governing professional ethics.
- Part 2 of Code of ethics sets out requirements and application material for professional accountants in service when applying the conceptual framework. It does not describe all of the facts and circumstances, including professional activities, interests and relationships that could be encountered by professional accountants in service, which create or might create threats to compliance with the fundamental principles. Therefore, the conceptual framework requires professional accountants in service to be alert for such facts and circumstances.
- Part 3 of Code of ethics sets out requirements and application material for professional accountants in public practice when applying the conceptual framework.
- Part 4A and 4B of Code of ethics deal with independence standards for audit and review engagements (Part 4A) and assurance engagements other than audit and review engagements (Part 4B) respectively.
- There are specific provisions in Chartered Accountants Act, 1949 dealing with professional misconduct and other misconduct.
- Acts or omissions which comprise professional misconduct within the meaning of the Chartered Accountants Act are defined in two Schedules viz. the First Schedule and the Second Schedule.
- The First Schedule is divided into four parts, Part I of the First Schedule deals with the misconduct of a member in practice which would have the effect generally of compromising his position as an independent person. Part II deals with misconduct of members in services.

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Part III deals with the misconduct of members generally and Part IV deals with other misconduct in relation to members of the institute generally.

- The Second Schedule is divided into three parts. Part I deals with misconduct in relation to a member in practice, Part II deals with misconduct of members generally and Part III deals with other misconduct in relation to members of the Institute generally.

ANNEXURE – 1

The Chartered Accountants Act, 1949

The Chartered Accountants Act, 1949 (No. 38 of 1949) came into force on the 1st day of July, 1949. Later in the year 1959, certain amendments were made therein through the Chartered Accountants (Amendment) Act, 1959 (No.15 of 1959). After about 47 years extensive changes have been made in the Act through the Chartered Accountants (Amendment) Act, 2006 (No.9 of 2006) which have been notified by the Central Government in the Gazette of India (Extra Ordinary) dated 23rd March, 2006. Further, few insertions were made to the principle Act through the Chartered Accountants (Amendment) Act, 2011 (No. 3 of 2012).

The entire Act is divided in nine chapters [Including chapter VIIA inserted by Chartered Accountants (Amendment) Act, 2006].

The Complete enumeration of Contents is given below:

Chapter I - Preliminary

1. Short title, Extent and Commencement
2. Interpretation

This Chapter contains preliminary aspects of the Act like applicability of the Act, definition of various terms like, Chartered Accountant, Council, holder of a restricted certificate, Registered Accountant, etc.

Chapter II - The Institute of Chartered Accountants of India

3. Incorporation of the Institute
4. Entry of names in the Register
5. Fellows and Associates
6. Certificate of Practice

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7. Members to be known as Chartered Accountants

8. Disabilities

This chapter deals with various things like who shall be entitled to have his name entered in the register of members of the Institute, who shall be deemed to have become an associate member of the Institute, who shall be entered in the Register as a fellow of the Institute. This Chapter also deals with issues relating to certificate of practice and disabilities of a person for having his name entered in the Register.

Chapter III - Council of the Institute

9. Constitution of the Council of the Institute

10. Re-election or re-nomination to Council [Substituted by Chartered Accountants (Amendment) Act, 2006]

10A. Settlement of dispute regarding election [Inserted by Chartered Accountants (Amendment) Act, 2006]

10B. Establishment of Tribunal [Inserted by Chartered Accountants (Amendment) Act, 2006]

11. Nomination in default of election or nomination

12. President and Vice-President

13. Resignation of Membership and casual vacancies

14. Duration and dissolution of the Council

15. Function of the Council

15A. Imparting education by Universities and Other bodies [Inserted by Chartered Accountants (Amendment) Act, 2006]

16. Officers and employees, salary, allowances etc. [substituted by Chartered Accountants (Amendment) Act, 2006]

17. Committees of the Council

18. Finances of the Council

This Chapter deals with various issues like composition of Council of the Institute, manner of conducting election to the Council, mode of tendering resignation from the membership of the Council mode of filling a casual vacancy, various duties of the Council. This Chapter also deals with

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the permission accorded to any University established by law or any Body affiliated to the Institute to impact education on the subjects covered by the academic courses of the Institute.

Chapter IV - Register of Members

19. Register of Members

20. Removal from the Register

This chapter deals with the matters relating to register of members and removal from the register the name of any member. The Council has to maintain a Register of Members of the Institute. This Register shall include name, date of birth, domicile, residential and professional address, qualification etc. Also, the Council may remove from the Register the name of any member in certain circumstances like in case of death of the member or if the member does not pay the prescribed fees, or when a member has become subject to any of the disabilities mentioned in section 8.

Chapter V - Misconduct

21. Disciplinary Directorate [Substituted by Chartered Accountants (Amendment) Act, 2006]

21A. Board of Discipline [Inserted by Chartered Accountants (Amendment) Act, 2006]

21B. Disciplinary Committee [Inserted by Chartered Accountants (Amendment) Act, 2006]

21C. Authority, Disciplinary Committee, Board of Discipline and Director (Discipline) to have powers of civil court [Inserted by Chartered Accountants (Amendment) Act, 2006]

21D. Transitional provisions [Inserted by Chartered Accountants (Amendment) Act, 2006]

22. Professional or other misconduct defined [Substituted by Chartered Accountants (Amendment) Act, 2006]

22A. Constitution of Appellate Authority [Substituted by Chartered Accountants (Amendment) Act, 2006]

22B. Term of office of Chairperson and members of Authority [Inserted by Chartered Accountants (Amendment) Act, 2006].

22C. Allowances and conditions of service of Chairperson and Members of Authority (Inserted by Chartered Accountants (Amendment) Act, 2006)

22D. Procedure to be regulated by Authority [Inserted by Chartered Accountants (Amendment) Act, 2006]

22E. Officers and other staff of Authority [Inserted by Chartered Accountants (Amendment) Act, 2006]

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22F. Resignation and removal of Chairperson and Members [Inserted by Chartered Accountants (Amendment) Act, 2006)]

22G. Appeal to Authority [Inserted by Chartered Accountants (Amendment) Act, 2006]

In this chapter professional and other misconduct has been defined. As per section 22 of the Act, the expression "professional or other misconduct " shall be deemed to include any act or omission provided in any of the Schedules. In this chapter, Section 21, 22 and 22A have been substituted by new sections 21, 22 and 22A. Other sections (Section 21A, 21B, 21C, 21D, 22B, 22C, 22D, 22E, 22F and 22G) have been inserted by Chartered Accountants (Amendment) Act, 2006. These Sections along with the Schedules deal with the new Disciplinary Mechanism.

Chapter VI - Regional Councils

23. Constitution and Functions of Regional Councils

The Councils may constitute such Regional Councils for the purpose of advising and assisting it on matters concerning its functions. The Regional councils shall exercise prescribed functions.

Chapter VII - Penalties

24. Penalty for falsely claiming to be a member etc.

24A. Penalty for using name of the Council, awarding degree of Chartered Accountancy etc.

25. Companies not to engage in accountancy

26. Unqualified persons not to sign documents

27. Maintenance of branch offices

28. Sanction to prosecute

This chapter lists penalties in various cases like, if a person who is not a member of the Institute and represents himself as a member of the Institute or uses the designation Chartered Accountant, he shall be punishable with fine which may extend to one thousand rupees (on first conviction) and with imprisonment which may extend to six months or with fine which may extend to five thousand rupees or with both (on subsequent conviction). Other provisions regarding penalties that are included in this chapter provide that a Company (Incorporated in or outside India) shall not practice as Chartered Accountant, a person other than a member of the Institute shall not sign any document an behalf of a Chartered Accountant in practice or a firm of such Chartered Accountants in his or its professional capacity, etc.

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Chapter VII A Quality Review Board

[Inserted by Chartered Accountants (Amendment) Act, 2006]

28A. Establishment of Quality Review Board

28B. Functions of Board

28C. Procedure of Board

28D. Terms and conditions of services of Chairperson and Members of Board and its expenditure

After Chapter VII, the Chapter VIIA has been inserted by the Chartered Accountants (Amendment) Act, 2006. It empowers the Central Government to constitute a Quality Review Board outside the framework of the Institute. It will perform the functions like, to make recommendations to the Council with regard to the quality of services provided by the members of the Institute, to review the quality of services provided by the members of the Institute including audit services and to guide the members of the Institute to improve the quality of services and adherence to the various statutory and other regulatory requirements.

Chapter VIII – Miscellaneous

29. Reciprocity

29A. Power of Central Government to make rules.

30. Power to make regulations

30A. Powers of the Central Government to direct regulation to be made or to make or amend regulations

30B. Rules, Regulations and notification to be laid before Parliament [Substituted by Chartered Accountants (Amendment) Act, 2006]

30C. Power of Central Government to issue directions [Inserted by Chartered Accountants (Amendment) Act, 2006)]

30D. Protection of action taken in good faith [Inserted by Chartered Accountants (Amendment) Act, 2006)]

30E. Members etc. to be public servants [Inserted by Chartered Accountants (Amendment) Act, 2006)]

31. Construction of References

32. Act not to affect right of accountants to practice as such in Acceding States.

33. [Repealed]

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This Chapter contains miscellaneous provisions. It empowers the Council to prescribe the conditions subject to which foreign qualifications relating to accountancy shall be recognized for the purpose of entry in the Register. It also empowers the Council to make regulations for the purpose of carrying out the objects of this Act. It also empowers the Central Government to direct the Council to make any regulations or to amend or revoke any regulations already made. Section 30C, 30D, and 30E have been inserted by Chartered Accountants (Amendment) Act, 2006. Section 30C empowers the Central Government to issue directions in the event of non-compliance by the Council of any provisions of the Act. Section 30D protects Central Government, Council, Authority Disciplinary Committee, Tribunal, Board, Board of Discipline, Disciplinary Directorate or any officer thereof, for anything which is in good faith done or intended to be done under this Act or any rule, regulation, notification, direction or order made there under. Section 30E says that the Chairperson, Presiding officer, Members and other officers and employees of the Authority, Disciplinary Committee, Tribunal, Board, Board of Discipline or the Disciplinary Directorate shall be deemed to be public servants within the meaning of Section 21 of the Indian Penal Code.

ANNEXURE – 2

SCHEDULES TO THE ACT

Acts or omissions which comprise professional misconduct within the meaning of Section 22 of the Chartered Accountants Act are defined in two Schedules viz. the First Schedule and the Second Schedule.

The First Schedule is divided into four parts, Part I of the First Schedule deals with the misconduct of a member in practice which would have the effect generally of compromising his position as an independent person. Part II deals with misconduct of members in services. Part-III deals with the misconduct of members generally and part IV deals with other misconduct in relation to members of the institute generally. The Second Schedule is divided into three parts. Part I deals with misconduct in relation to a member in practice, Part II deals with misconduct of members generally and part III deals with other misconduct in relation to members of the Institute generally. The implication of the different clauses in the schedules are discussed below:

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The First Schedule

PART I - Professional misconduct in relation to Chartered Accountants in practice

A Chartered Accountant in practice is deemed to be guilty of professional misconduct if he:

Clause (1) allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him.

Clause (2) pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

Clause (3) accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute.

Clause (4) enters into partnership, in or outside India, with any person other then Chartered Accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under close (V) of sub-section (1) of section 4 or whose qualifications are recognized by the Central Government or the Council for the purpose of permitting such partnerships.

Clause (5) secures either through the services of a person who is not an employee of such Chartered Accountant or who is not his partner or by means which are not open to a Chartered Accountant, any professional business.

Provided that nothing herein contained shall be construed as prohibiting any agreement permitted in terms of item (2), (3) and (4) of this part.

Clause (6) solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Provided that nothing herein contained shall be construed as preventing or prohibiting -

(i) Any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice; or

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(ii) A member from responding to tenders or enquiries issued by various users of professional services or organizations from time to time and securing professional work as a consequence.

However, as per the guideline issued by the Council of the Institute of Chartered Accountants of India, a member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for chartered accountants, such as audit and attestation services. However, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.

Clause (7) advertises his professional attainments or services, or uses any designation or expressions other than the Chartered Accountant on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a University established by law in India or recognized by the Central Government or a title indicating membership of the Institute of Chartered Accountants or of any other institution that has been recognized by the Central Government or may be recognized by the Council.

Provided that a member in practice may advertise through a write up, setting out the service provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council.

Clause (8) accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been Issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing.

Clause (9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 (1 of 1956), or sections 139 to 141 of the Companies Act, 2013 or any other law pertaining to appointment of auditors for the time being in force, in respect of such appointment have been duly complied with.**

(Now Section 139 and 140 read with Section 141 of the Companies Act, 2013. Students may note that till the time Code of Ethics etc. bare documents get updated from Ethical Standard Board of ICAI in pursuance of the Companies Act, 2013, students are required to understand the basic nature of the provision and quote the same along with the new corresponding provisions.)

Clause (10) charges or offers to charge, accepts or offers to accept In respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the

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findings, or results of such employment, except as permitted under any regulations made under this Act.

The Council of the Institute has however framed Regulation 192 which exempts members from the operation of this clause in certain professional services.

Clause (11) engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company (Not being managing director or a whole time director) unless he or any of his partners is interested in such company as an auditor.

Clause (12) allows a person not being a member of the institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

PART II - Professional misconduct in relation to members of the Institute in service

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person:

Clause (1) pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him.

Clause (2) accepts or agrees to accept any part of fees, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

[Note: A member in the foregoing circumstances would be guilty of misconduct regardless of the fact that he was in whole-time or part-time employment or that he was holding Certificate of Practice along with his employment.]

PART III - Professional misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he:

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he:

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Clause (1) not being a fellow of the Institute, acts as a fellow of the Institute.

Clause (2) does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority.

Clause (3) while inviting professional work from another chartered accountant or while responding to tenders or enquiries or while advertising through a write up, or anything as provided for in items (6) and (7) of Part I of this Schedule, gives information knowing it to be false.

PART IV - Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he:

(1) is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months.

(2) in the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

These clause (1) & (2) are self explanatory and any of the member of the Institute is found guilty by any civil or criminal court and prosecuted for an imprisonment in an offence involving moral turpitude or his acts bring disrepute to the profession or the Institute, irrespective of the fact whether such acts are related to profession or not, such member will be deemed to be guilty of other misconduct in Part IV of Schedule I.

The important point to note is that if imprisonment tenure exceeds six months, this case will be covered in the clause of Part III of Schedule II.

The Second Schedule

PART I - Professional misconduct in relation to chartered Accountant in practice

A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he:

Clause (1) discloses Information acquired in the course of his professional engagement to any person other than his client so engaging him without the consent of his client or otherwise than as required by any law for the time being in force.

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Clause (2) if he certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee In his firm or by another chartered accountant in practice.

Clause (3) permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast.

Clause (4) expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.

Clause (5) fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement not misleading where he is concerned with that financial statement in a professional capacity.

Clause (6) fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

Clause (7) does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

Clause (8) fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.

Clause (9) fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

Clause (10) fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

PART II - Professional misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he:

Clause (1) contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

Clause (2) being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being

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in force or except as permitted by the employer.

Clause (3) includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline. Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

Clause (4) defalcates or embezzles money received in his professional capacity.

Clause (5) acts as an auditor of the company in contravention of the provisions of the Companies Act, 2013.

Part III - Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

Imprisonment awarded for a term exceeding six months in any civil/criminal matter treated as a major offence under 'other misconduct' is included in this Schedule.

Where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the second schedule or in both the Schedule, he shall place the matter before the Disciplinary Committee.

Recent Decisions of Ethical Standards Board

1. ***It is not permissible for member in practice being a statutory auditor to prepare Business Responsibility & Sustainability Reporting (BRSR) study to Audit Clients. However, he may provide advisory services on the same. It is permissible for member in practice being a statutory auditor to be "Assurance provider of BRSR core" (Ref. SEBI circular dt. 12.07.2023) for the same client.***
2. ***Statutory auditor of an entity is not permitted to engage in assignment of compilation engagement, of that entity as per SRS 4410.***
3. ***It is permissible for members in practice to engage in the services assessment/performance audit of the centres of skill development council of Government of India as these are permissible under Management Consultancy and other services issued under section 2(2)(iv) of Chartered Accountants Act, 1949.***
4. ***It is permissible for a member in practice to accept the assignment of Mystery Audit.***
5. ***It is permitted for a member in practice to mention position as promoter/Director on the portal of a Company. However, the member cannot mention his professional attainments and the name of the firm with which he is associated. There should be no***

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violation of clause (6) and Clause (7) of Part-I of First Schedule to the Chartered Accountants Act, 1949 in doing so.

6. ***It is permissible for a member in practice to become professional director in the Board of Management of a Co-operative Bank.***

7. ***It is permissible for a member to set up practice in IFSC/GIFT city.***

8. ***It is permissible for a member to render professional services to IFSC units from offices outside IFSC.***

9. ***A firm is not permitted to publish its vision or mission statement on letter head, visiting card or stationery etc. The vision and mission statement may be printed on the firm profile and may be provided in response to a specific request.***

10. ***It is not permissible for a member/ firm being the statutory Auditor of a Bank to accept the assignment of ASM of a customer of the same Bank simultaneously. He can accept either of the Assignments at one time.***

11. ***A member in practice cannot be appointed as an Internal Auditor and Procurement officer simultaneously in an organization.***

12. ***It is permissible for members in practice to charge fees on a percentage of utilization amount of an educational Institute for certifying the amount (utilization) spent by an educational Institute out of grant.***

13. It is not permissible for a member in practice to accept the appointment of statutory audit of the society wherein immediate family member i.e., spouse or dependent, of member hold honorary position of one of the managing committee of the institutes governed by the society.

14. There is no conflict of interest in a Chartered Accountant, who is a member of a Trust, being the auditor of the said trust. It is subject to the exception where a particular statute governing a Trust prescribes prohibition on the member of the Trust to be its Auditor or otherwise where there is conflict of interest as per the provisions of Code of Ethics.

15. It is not permissible for a member to use Messaging Applications to send messages to make people aware about his practice, and mention the services provided therein.

16. It is permissible for a practicing Chartered Accountant holding Certificate of Practice to become a member of the 'Board of Management' in Primary (Urban) Co-operative Banks. The Ethical Standards Board noted that the position of a member of 'Board of Management' in Primary (Urban) Co-operative banks (UCBs) and the role attached to that position is similar

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to that of a Director-Simiplicitor; where there is no involvement of a member in the day-to-day functioning/operations and not signatory etc. and only sitting fees for the services rendered are provided.

17. Member in practice cannot act as Trademark or Patent Attorney. However, Professional advice in relation to Intellectual Property Rights (IPR) is a routine professional work for a Chartered Accountants in practice and same is permissible under the provisions of the Chartered Accountants Act, 1949.

18. There is no prohibition for internal auditor of a company to acquire/purchase shares of the said Company.

19. A CA Firm may register itself on Udyog Aadhar, a web portal of Ministry Micro, Small and Medium Enterprises.

20. A chartered accountant in practice can provide services through kiosk only if the services provided are professional activities of a practicing chartered accountant, permitted under the Act.

21. It is permissible for two or more Chartered Accountants in practice collectively to have joint training session for their clients on GST, and share the fees collected from the clients thereof.

22. A Member in practice may be a Non-executive/independent director in a Co-operative Bank, provided he is not involved into day to day activity of the organization, nor he or any of his partners are interested in the Bank as an auditor.

23. A Chartered Accountant in practice being Director Simplicitor in a Company cannot sign ROC Forms of the Company as it is a direct conflict of role.

24. A Chartered Accountant in practice can act as Authorized Representative of a Foreign Company, provided he is not the auditor of the said Company.

25. A Chartered Accountant in service is allowed to take e-return registration if it does not conflict with employment obligation. However, he cannot certify the return.

26. In case where Chartered Accountant in practice is a non-executive director in a company, he or a Firm in which he is a partner, should not accept the appointment as a statutory auditor of a Company which is a joint venture of the original Company, as it would impact independence.

27. A Chartered Accountant in practice may be an equity research adviser, but he cannot publish retail report, as it would amount to other business or occupation.

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28. A Chartered Accountant in practice may engage himself as Registration Authority (RA) for obtaining digital signatures for clients.

29. A Chartered accountant can hold the credit card of a bank when he is also the auditor of the bank, provided the outstanding balance on the said card does not exceed Rs 100,000* beyond the prescribed credit period limit on credit card given to him. (*As per the limit of indebtedness existing as on date.)

30. A Chartered Accountant in practice can act as mediator in Court, since acting as a "mediator" would be deemed to be covered within the meaning of "arbitrator'; which is inter-alia permitted to members in practice as per Regulation 191 of the Chartered Accountants Regulations, 1988.

31. A Chartered Accountant in practice is not permitted to accept audit assignment of a bank in case he has taken loan against a Fixed Deposit held by him in that bank.

32. The Ethical Standards Board in 2013 generally apply the stipulations contained in the then amended Rule 11U of Income Tax generally, wherein statutory auditor /tax auditor cannot be the valuer of unquoted equity shares of the same entity. The Board has at its recent Meeting (January, 2017) has reviewed the above, and decided that where law prohibits for instance in the Income Tax Act and the rules framed thereunder, such prohibition on statutory auditor/tax auditor to be the valuer will continue, but where there is no specific restriction under any law, the said eventuality will be permissible, subject to compliance with the provisions, as contained in the Code of Ethics relating to independence.

33. The Ethical Standards Board had in 2011 decided that it is not permissible for a member who has been Director of a Company, upon resignation from the Company to be appointed as an auditor of the said Company, and the cooling period for the same may be 2 years. The Board has at its recent Meeting (January, 2017) has reviewed the above, and noted that the Section 141 of the Companies Act, 2013 on disqualification of auditors does not mention such prohibition; though threats pertaining to the said eventuality have been mentioned in Code of Ethics. Further, the Board was of the view that a member may take decision in such situation based on the provisions of the Companies Act, 2013 and provisions of Code of Ethics.

34. A chartered accountant in practice cannot become Financial Advisors and receive fees/commission from Financial Institutions such as Mutual Funds, Insurance Companies, NBFCs etc.

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35. A chartered accountant cannot exercise lien over the client documents/records for non-payment of his fees.

36. It is not permissible for CA Firm to print its vision and values behind the visiting cards, as it would result in solicitation and therefore would be violative of the provisions of Clause (6) of Part-I of First Schedule to the Chartered Accountants Act, 1949.

37. It is not permissible for chartered accountants in practice to take agencies of UTI, GIC or NSDL.

38. It is permissible for a member in practice to be a settlor of a trust.

39. A member in practice cannot hold Customs Brokers Licence under section 146 of the Customs Act, 1962 read with Customs Brokers Licensing Regulations, 2013 in terms of the provisions of Code of Ethics.

40. A Chartered accountant in service may appear as tax representative before tax authorities on behalf of his employer, but not on behalf of other employees of the employer.

41. A chartered accountant who is the statutory auditor of a bank cannot for the same financial year accept stock audit/inspection Audit of the same branch of the bank or any of the branches of the same bank or sister concern of the bank, for the same financial year.

42. A CA Firm which has been appointed as the internal auditor of a PF Trust by a Government Company cannot be appointed as its Statutory Auditor.

43. A concurrent auditor of a bank 'X' cannot be appointed as statutory auditor of bank 'Y', which is sponsored by 'X'.

44. A CA/CA Firm can act as the internal auditor of a company & statutory auditor of its employees PF Fund under the new Companies Act (2013).

45. The Ethical Standards Board while noting that there is requirement for a Director u/s 149(3) of the Companies Act, 2013 to reside in India for a minimum period of 182 days in the previous calendar year, decided that such a Director would be within the scope of Director Simplicitor (which is generally permitted as per ICAI norms) , if he is non –executive director, required in the Board Meetings only , and not paid any remuneration except for attending such Board Meetings.

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TEST YOUR KNOWLEDGE

Theoretical Questions

1. *P, a Chartered Accountant in practice provides management consultancy and other services to his clients. During 2024, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients. Is P guilty of professional misconduct?*

2. *Mr. G, a Chartered Accountant in practice as a sole proprietor has an office in Mumbai near Church Gate. Due to increase in professional work, he opens another office in a suburb of Mumbai which is approximately 80 kilometers away from the municipal limits of the city. For running the new office, he employs three retired Income-tax Officers. Is Mr. G guilty of professional misconduct?*

3. *Write a short note on Other Misconduct.*

4. *Mr. K, a practicing Chartered Accountant gave 50% of the audit fees received by him to a non-Chartered Accountant, Mr. L, under the nomenclature of office allowance and such an arrangement continued for a number of years. Discuss this in the light of Professional Ethics issued by ICAI.*

5. *Mr. X who passed his CA examination of ICAI on 18th July, 2024 and started his practice from August 15, 2024. On 16th August 2024, one female candidate approached him for articleship. In addition to monthly stipend, Mr. X also offered her 1 % profits of his CA firm. She agreed to take both 1 % profits of the CA firm and stipend as per the rate prescribed by the ICAI. The Institute of Chartered Accountants of India sent a letter to Mr. X objecting the payment of 1 % profits. Mr. X replies to the ICAI stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the financial position of the articled clerk is very weak. Is Mr. X liable to professional misconduct?*

6. *M/s XYZ, a firm in practice, develops a website "xyz.com". The colour chosen for the website was a very bright green and the web-site was to run on a "push" technology where the names of the partners of the firm and the major clients were to be displayed on the web-site without any disclosure obligation from any regulator. Is this website in compliance with guidelines issued by ICAI in this regard?*

7. *A partner of a firm of chartered accountants during a T.V. interview handed over a bio-data of his firm to the chairperson. Such bio-data detailed the standing of the international firm*

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with which the firm was associated. It also detailed the achievements of the concerned partner and his recognition as an expert in the field of taxation in the country. The chairperson read out the said bio-data during the interview. Discuss whether this action by the Chartered Accountant would amount to misconduct or not.

8. (a) *An advertisement was published in a Newspaper containing the photograph of Mr. X, a member of the institute wherein he was congratulated on the occasion of the opening ceremony of his office.*

   (b) *Mr. X, a Chartered Accountant and the proprietor of X & Co., wrote several letters to the Assistant Registrar of Co-operative Societies stating that though his firm was on the panel of auditors, no audit work was allotted to the firm and further requested him to look into the matter.*

9. *A practising Chartered Accountant uses a visiting card in which he designates himself, besides as Chartered Accountant, Cost Accountant. Is this a misconduct?*

10. *Mr. Nigal, a Chartered Accountant in practice, delivered a speech in the national conference organized by the Ministry of Textiles. While delivering the speech, he told to the audience that he is a management expert and his firm provides services of taxation and audit at reasonable rates. He also requested the audience to approach his firm of chartered accountants for these services and at the request of audience he also distributed his business cards and telephone number of his firm to those in the audience. Comment.*

11. *Mr. A is a practicing Chartered Accountant working as proprietor of M/s A & Co. He went abroad for 3 months. He delegated the authority to Mr. Y a Chartered Accountant his employee for taking care of routine matters of his office. During his absence Mr. Y has conducted the under mentioned jobs in the name of M/s A & Co.*

    (i) He issued the audit queries to client which were raised during the course of audit.

    (ii) He issued production certificate to a client under the GST Act.

    (iii) He attended the Income Tax proceedings for a client as authorized representative before Income Tax Authorities.

    Please comment on eligibility of Mr. Y for conducting such jobs in name of M/s A & Co. and liability of Mr. A under the Chartered Accountants Act, 1949.

12. *XYZ Co. Ltd. has applied to a bank for loan facilities. The bank on studying the financial statements of the company notices that you are the auditor and requests you to call at the bank for a discussion. In the course of discussions, the bank asks for your opinion regarding*

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the company and also asks for detailed information regarding a few items in the financial statements. The information is available in your working paper file. What should be your response and why?

13. *Mr. A, a newly qualified Chartered Accountant, started his practice and sought clients through telephone calls from his family and friends, almost all of them employed in one or the other retail trade business. One of his friends Mr. X gave him an idea to start online services and give stock certifications to traders with Cash Credit Limits in Banks. Mr. A started a website with colorful catchy designs and shared the website address on his all social media posts and stories and tagged 30 traders of his local community with the caption "Easy Online Stock Certification Services". Discuss if the actions of Mr. A are valid in the light of the Professional Ethics and various pronouncements and guidelines issued by ICAI.*

14. *Mr. D, a practicing CA, is appointed as a Director Simplicitor in XYZ Pvt. Ltd. After one year of appointment, Mr. D resigned as the Director and accepted the Statutory Auditor position of the company. Is Mr. D right in accepting the auditor position?*

15. *Mr. F, a Chartered Accountant, gave advisory services to PQR Pvt. Ltd. Further, he gave them GST consultancy, compilation engagement for historical financial information and helped in ERP set up. Later, the company turned out to be a part of a group of companies involved in money laundering. Mr. F was asked to provide details of the companies. Mr. F refused on the grounds that he gave only consultancy services to the company and wasn't supposed to keep any information about the company. Is Mr. F right as per the guidelines issued by the ICAI?*

16. *Mr. S, the auditor of ABC Pvt. Ltd. has delegated following works to his articles and staff:*

    i. *Issue of audit queries during the course of audit.*

    ii. *Issue of memorandum of cash verification and other physical verification.*

    iii. *Letter forwarding draft observations/financial statements.*

    iv. *Issuing acknowledgements for records produced.*

    v. *Signing financial statements of the company.*

    Is this correct as per the Professional Ethics and ICAI's guidelines and pronouncements?

17. *Mr. S is a practising chartered accountant based out of Chennai. During the weekends, he involved himself in equity research and used to advise his friends, relatives and other known people who are not his clients. Apart from this, he was also involved as a paper-setter for*

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Accountancy subject in the school in which he studied. He also owned agricultural land and was doing agriculture during his free time. During the year 20X1, heavy losses were incurred in agricultural activity due to natural calamities and misfortune, and he lost almost all of his wealth and became undischarged insolvent. After a few court hearings, finally, in the year 20X3, he was declared discharged insolvent and obtained a certificate from the court stating that his insolvency was caused by misfortune without any misconduct on his part. You are required to comment on the above situation with reference to the Chartered Accountants Act, 1949 and Schedules thereto, (especially from the point of section 8: Entry of name in Register of Members).

18. ***CA Pankaj accepted professional work of acting as valuer under direct taxes. He charges fees on a percentage of the property valued. Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto.***

19. ***Mr. Johny, a chartered accountant, was invited to a seminar on bank audits to give a presentation on the process of conducting such audits. During his presentation, he provided examples from his clients' experiences and shared the significant information about clients with the intention of aid in understanding of audience on the topic. Does above situation have implications in relation to the professional ethics?***

20. ***CA Vaayu is the auditor of Viva Limited having a turnover of more than ₹ 200 Crores. The audit fee for the year is fixed at ₹ 80 Lakhs. During the year, the company offers CA Vaayu an assignment of representation before Income Tax Appellate Tribunal for certain matter for remuneration of ₹ 1.75 crores. CA Vaayu accepted the assignment. Discuss action of CA Vaayu with reference to the provisions of the Chartered Accountants (Amendment) Act, 2006 and Schedules thereto.***

21. ***Sanjeev & Associates, a firm of Chartered Accountants responded to a tender from a PF Office, Chembur for filing quarterly e-TDS returns. The terms of tender are as follows:***

    (i) Earnest Money Deposit of ₹ 7,500/-

    (ii) It is open for all categories

    (iii) Maximum fees of ₹ 7,500/- per quarter

    Discuss whether Sanjeev and Associates can respond to the said tender with reference to provisions of the Chartered Accountants (Amendment) Act, 2006 and Schedules thereto.

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22. *CA Shubh, a Chartered Accountant in practice specializing in the field of Information Systems Audit. He is considered to be one of the experts in this field because of his command over the subject. ZX Limited, a company engaged in rendering management consultancy offered him to appoint as its managing director. CA Shubh accepted the position of managing director without obtaining prior permission from the Institute. One of his friends, CA Varun informed him that now he cannot retain full time certificate of practice, thus cannot do attestation function and train articled assistants. Comment with reference to the provisions of the Chartered Accountants Act, 1949 and Schedules thereto.*

23. *Pitch Private Limited requested CA Angad, a practicing Chartered Accountant, to digitally sign the form related to resignation of Mr. Ravi, one of the Director of Pitch Private Limited, along with the copy of resignation letter to be uploaded on the website of Registrar of Companies. The signature of Mr. Ravi was simply copied and pasted by another Director of Pitch Private Limited. CA Angad, without verifying the genuineness of the resignation letter, digitally signed the form and the said form was uploaded on the website of Registrar of Companies. Comment with reference to the provisions of the Chartered Accountants Act, 1949 and Schedules thereto.*

24. *Shri Limited, a listed Company, having its registered office at Mumbai is engaged in manufacturing of various types of yarns to be supplied to the textile mills. The Company has installed pollution control equipment for processing the pollutants so that before discharge of effluents outside the factory, the level of pollution is kept at a level below the prescribed standard. The company managed to get the pollution clearance certificate by unfair means, while still there continues to be breach of pollution control laws in matters of discharge of polluting effluents. The amount of ₹ 18.75 Lacs had been incurred for arranging clearance certificate and the amount incurred unlawfully had been booked as pollution recycling expenditure. The matter had not reached those in governance, and the Director-Finance, who is a Chartered Accountant, came to know of these matters on review of major expenditure incurred during the period. Comment on the action/responses expected of Director - Finance (CA Gopal) referring to any applicable requirements of Responses for NOCLAR under Code of Ethics.*

25. *CA Kapila, in practice, is desirous of filling Multi-purpose Empanelment Form (MEF) for inclusion of her name in panel for allotment of statutory audit of bank branches web hosted by Professional Development Committee (PDC) of ICAI for financial year*

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2023-24. The form requires applicants to upload XML files of their personal income tax returns along with computation of income. During relevant year for which information is being sought by PDC, CA Kapila has transacted in futures and options derivatives (equity) and has reflected income from such transactions in her return of income as "Business Income". Analyse the above situation with reference to the provisions of the Chartered Accountants Act, 1949.

Would it make any difference if CA Kapila had earned income from transacting in currency derivatives and commodity derivatives?

26. *In terms of subsection 114 of Revised Code of Ethics, a professional accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as result of professional and employment relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant in knowledge that the information will not be disclosed to a third party. In this context, enumerate the circumstances where professional accountants are or might be required to disclose confidential information or when such disclosure might be appropriate. In deciding whether to disclose confidential information what are the points that should be kept in the mind of professional accountants?*

27. *CA Raj, a practicing chartered accountant, is offered to take up an appointment as a "Secretary" in his professional capacity by the Central Government for a Metro Project for a term of 2 years not on a salary-cum-full-time basis. After giving deep thought to the offer, CA Raj accepted the appointment. Comment in terms of the Chartered Accountant Act, 1949 and Schedules thereto.*

28. *TP Limited is a listed company engaged in the business of manufacturing of kids garments under the brand name of MM. M/s R & Associates, firm of chartered accountants, are appointed as a Statutory Auditor of the Company for the year 2023-24. CA R is looking after the audit of the Company. During the audit, CA R observed that there are number of notices received from GST Department and Income-tax Department for various issues. Further during plant visit, CA R observed that few child labourers are engaged in some of the activity. In response to the observation made, CA R followed the procedure as envisaged in SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". According to CA R, the provisions of SA 250 and the provisions of NOCLAR (Non-Compliance with Laws and Regulations)*

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under Revised Code of Ethics are one and the same. Do you agree? If not, give your comments.

29. *CA Kumar, a practicing-chartered accountant, is well known in the field of pleading of Income-tax cases at Income-tax Tribunal and does not provide any assurance services. Considering the long standing in the field, CA Kumar is approached by XYZ Limited to file an appeal in the Tribunal against the Income-tax Demand of ₹ 10 crore which was added by the CIT(A) and to plead on behalf of XYZ Limited in the matter. CA Kumar offers to accept the case with the following fee structure:*

The fees for filing an appeal and to plead at the Income-tax Tribunal will be 10% of Tax Demand Reduced.

Comment on the act of CA Kumar in terms of the Chartered Accountant Act, 1949 and Schedules thereon.

30. *GeM (e-market place) is a public procurement portal which provides opportunities to start-ups, entrepreneurs etc. to showcase their innovative products and services to government buyers and engage in public procurement. The Government e Marketplace Special Purpose Vehicle (GeM SPV), a 100% government owned and section 8 (Non-Profit) company under the Ministry of Commerce, Government of India has been incorporated under the Companies Act, 2013 to develop, manage and maintain GeM platform. Whether a firm of Chartered Accountants can register on GeM portal for rendering professional services to government departments?*

31. *CA Gyan is a Chartered Accountant in practice and also an engineer by qualification. He wants to pursue a registered valuer course and work as a registered valuer for plant and machinery under the Companies Act, 2013. Comment on above with reference to provisions of the Chartered Accountants Act, 1949.*

32. *CA Evan has been in practice for two years and runs his proprietorship firm in the name of "Evan & Co.". He maintains notes in his mobile where he records the fees received from various clients. Using these records, he prepares and files his income tax return. Comment with respect to the provisions of the Chartered Accountant Act, 1949.*

33. *The manager of Miskin (P) Ltd. approached CA Rahul in need of a certificate in respect of a consumption statement of raw material. Without having a certificate of practice (CoP), CA Rahul issued the certificate to the manager of the company, acting as a CA*

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in practice and applied for the CoP to the Institute on very next day to avoid any dispute.

34. ***A special notice has been issued for a resolution at 4th annual general meeting of TRIM Ltd., providing expressly that CA Lucky shall not be re-appointed as an auditor of the company. Consequently, CA Lucky submitted a representation in writing to the company with a request to circulate to the members. In the detailed representation, CA Lucky included the contributions made by him in strengthening the control procedures of the company during his association with the company and also indicated his willingness to continue as an auditor if reappointed by the shareholders of the company. Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto.***

35. ***CA Anita joined as an audit executive in a CA firm on April 1, 2024. Despite receiving multiple*** **reminders from ICAI, she has failed to respond with her appointment date and submit her membership certificate. Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto.**

Hints/Answers to Theoretical Questions

1. **Advising on Portfolio Management Services:** The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "Management Consultancy and other Services" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

   In view of this, P would be guilty of misconduct under the Chartered Accountants Act, 1949.

2. In terms of section 27 of the Chartered Accountants Act, 1949, if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. There is however an exemption for the above if the second office is located in the same premises, in which the first office is located; or the second office is located in the same city, in which the first office is located; or the second office is located within a distance of 50 kms from the municipal limits of a city, in which the first office

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is located. Since the second office is situated beyond 50 kms of municipal limits of Mumbai city, he would be liable for committing a professional misconduct.

3. Refer Para 7.2

4. **Sharing of Audit Fees with Non-Member:** As per Clause (2) of Part I of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant in practice pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

In the instant case, Mr. K, a practising Chartered Accountant gave 50% of the audit fees received by him to a non-Chartered Accountant, Mr. L, under the nomenclature of office allowance and such an arrangement continued for a number of years. In this case, it is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

The Chartered Accountant had shared his profits and, therefore, Mr. K will be held guilty of professional misconduct under the Clause (2) of Part I of First Schedule to the Chartered Accountants Act, 1949.

5. **Sharing Fees with an Articled Clerk:** As per Clause (2) of Part I of First Schedule to the Chartered Accountants Act 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

In view of the above, the objections of the Institute of Chartered Accountants of India, as given in the case, are correct and reply of Mr. X, stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the position of the articled clerk is weak is not tenable.

Hence, Mr. X is guilty of professional misconduct in terms of Clause (2) of Part I of First Schedule to the Chartered Accountants Act 1949.

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6. **Posting of Particulars on Website:** The Council of the Institute had approved posting of particulars on website by Chartered Accountants in practice under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949 subject to the prescribed guidelines. The relevant guidelines in the context of the website hosted by M/s XYZ are:

- No restriction on the colours used in the website;
- The websites are run on a "pull" technology and not a "push" technology;
- Names of clients and fees charged not to be given.

However, disclosure of names of clients and/or fees charged, on the website is permissible only where it is required by a regulator, whether or not constituted under a statute, in India or outside India, provided that such disclosure is only to the extent of requirement of the regulator. Where such disclosure of names of clients and/or fees charged is made on the website, the member/ firm shall ensure that it is mentioned on the website [in italics], below such disclosure itself, that "This disclosure is in terms of the requirement of [name of the regulator] having jurisdiction in [name of the country/area where such regulator has jurisdiction] vide [Rule/ Directive etc. under which the disclosure is required by the Regulator].

In view of the above, M/s XYZ would have no restriction on the colours used in the website but failed to satisfy the other two guidelines. Thus, the firm would be liable for professional misconduct since it would amount to soliciting work by advertisement.

7. Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits solicitation of client or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means since it shall constitute professional misconduct. The bio-data was handed over to the chairperson during the T.V. interview by the Chartered Accountant which included details about the firm and the achievements of the partner as an expert in the field of taxation. The chairperson simply read out the same in detail about association with the international firm as also the achievements of the partner and his recognition as an expert in the field of taxation. Such an act would definitely lead to the promotion of the firms' name and publicity thereof as well as of the partner and as such the handing over of bio-data cannot be approved. The partner would be held guilty of professional miscount under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

8. (a) **Publishing an Advertisement Containing Photograph:** As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or

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professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. X published an advertisement in a Newspaper containing his photograph on the occasion of the opening ceremony of his office. On this context, it may be noted that the advertisement which had been put in by the member is quite prominent. If soliciting of work is allowed, the independence and forthrightness of a Chartered Accountant in the discharge of duties cannot be maintained.

The above therefore amounts to soliciting professional work by advertisement directly or indirectly. Mr. X would be therefore held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(b) **Soliciting Professional Work:** As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. X, a Chartered Accountant and proprietor of M/s X and Co., wrote several letters to the Assistant Registrar of Co-operative Societies, requesting for allotment of audit work. In similar cases, it was held that the Chartered Accountant would be guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949. The writing of continuous letter to ascertain the reasons for not getting the work is quite alright but in case such either amount to request for allowing the work then Mr. X will be liable for professional misconduct.

Consequently, Mr. X would therefore be held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

9. **Cost Accountant:** As stated in the Illustration given in clause 7 with reference to tax consultant, this would also constitute misconduct under section 7 of the Act read with Clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949. A chartered accountant in practice cannot use any other designation than that of a chartered accountant. Nevertheless, a member in practice may use any other letters or descriptions indicating membership of accountancy bodies which have been approved by the Council. Thus, it is improper for a chartered accountant to state in his documents that he is a "Cost Accountant". However as per the Chartered Accountants Act, 1949, the Council has resolved that the

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members are permitted to use letters indicating membership of the Institute of Cost and Works Accountants but not the designation "Cost Accountant".

10. **Using Designation Other Than a CA and Providing Details of Services Offered:** Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

Section 7 of the Chartered Accountants Act, 1949 read with Clause (7) of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public. Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council.

Member may appear on television and films and agree to broadcast in the Radio or give lectures at forums and may give their names and describe themselves as Chartered Accountants. Special qualifications or specialized knowledge directly relevant to the subject matter of the programme may also be given but no reference should be made, in the case of practicing member to the name and address or services of his firm. What he may say or write must not be promotional of his or his firm but must be an objective professional view of the topic under consideration.

Thus, it is improper to use designation "Management Expert" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council. Therefore, he is deemed to be guilty of professional misconduct under both Clause (6) and Clause (7) as he has used the designation “Management Expert” in his speech and also he has made reference to the services provided by his firm of Chartered Accountants at reasonable rates. Distribution of cards to audience is also a misconduct in terms of Clause (6).

11. **Delegation of Authority to the Employee:** As per Clause (12) of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be

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guilty of professional misconduct "if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements".

In this case CA A proprietor of M/s A & Co., went to abroad and delegated the authority to another Chartered Accountant Mr. Y, his employee, for taking care of routine matters of his office who is not a partner but a member of the Institute of Chartered Accountants

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated and such delegation will not attract provisions of this clause like issue of audit queries during the course of audit, asking for information or issue of questionnaire, attending to routing matters in tax practice, subject to provisions of Section 288 of Income Tax Act etc.

(i) In the given case, Mr. Y, a chartered accountant being an employee of M/s A & Co. has issued audit queries which were raised during the course of audit. Here Y is right in issuing the query, since the same falls under routine work which can be delegated by the auditor. Therefore, there is no misconduct in this case as per Clause (12) of Part I of First schedule to the Act.

(ii) Further, issuance of production certificate to a client under GST Act by Mr. Y being an employee of M/s A & Co. (an audit firm), is not a routine work and it is outside his authorities. Thus, CA A is guilty of professional misconduct under Clause (12) of Part I of First Schedule of the Chartered Accountants Act, 1949.

(iii) In this instance, Mr. Y, CA employee of the audit firm M/s A & Co. has attended the Income tax proceedings for a client as authorized representative before Income Tax Authorities. Since the council has allowed the delegation of such work, the chartered accountant employee can attend to routine matter in tax practice as decided by the council, subject to provisions of Section 288 of the Income Tax Act. Therefore, there is no misconduct in this case as per Clause (12) of Part I of First schedule to the Act.

12. As per Clause (1) of Part I of the Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of the client or otherwise than as required by law for the time being in force. SA 200 on " Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" also reiterates that, "the auditor should respect the confidentiality of information acquired in the course of his work

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and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose".

In the instant case, the bank has asked the auditor for detailed information regarding a few items in the financial statements available in his working papers. Having regard to the position stated earlier, the auditor cannot disclose the information in his possession without specific permission of the client. As far as working papers are concerned, working papers are the property of the auditor. The auditor may at his discretion, make portions of or extracts from his working papers available to his client".

Thus, there is no requirement compelling the auditor to divulge information obtained in the course of audit and included in the working papers to any outside agency except as and when required by any law.

13. As per Clause (6) of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Mr. A is wrong in seeking clients through family and friends. Creating a website is not a non-compliance provided it is in line with the guidelines issued by the Institute in this regard. One of the guidelines is that the website should not be in push mode. Further, mentioning of clients' names is also prohibited as per the guidelines.

In the given situation, Mr. A shared the website address on his all social media posts and stories and tagged 30 traders of his local community with the caption "Easy Online Stock Certification Services" mentioning his current clients as well. This is in complete contravention of the guidelines on the website issued by the ICAI.

Thus, CA A would be held guilty of professional misconduct under clause 6 of Part 1 of First Schedule of the Chartered Accountants Act, 1949.

14. As per Clause (4) of Part I of the Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.

Section 141 of the Companies Act, 2013 specifically prohibits a member from auditing the accounts of a company in which he is an officer or employee. Although the provisions of the aforesaid section are not specifically applicable in the context of audits performed under other statutes, e.g. tax audit, yet the underlying principle of independence of mind is equally

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applicable in those situations also. Therefore, the Council's views are clarified in the following situations.

As per the clarifications issued by the Council, a member shall not accept the assignment of audit of a Company for a period of two years from the date of completion of his tenure as Director, or resignation as Director of the said Company.

In the instant case, Mr. D, a practicing CA, is appointed as a Director Simplicitor in XYZ Pvt. Ltd. After one year of appointment, Mr. D resigned as the Director and accepted the Statutory Auditor position of the company. In view of the above provisions Mr. D cannot accept the Directorship of the company until the completion of two years after his resignation.

Thus, CA D would be held guilty of professional misconduct under clause 4 of Part 1 of Second Schedule of the Chartered Accountants Act, 1949.

15. The financial services industry globally is required to obtain information of their clients and comply with Know Your Client Norms (KYC norms). Keeping in mind the highest standards of Chartered Accountancy profession in India, the Council of ICAI issued such norms to be observed by the members of the profession who are in practice.

In the given situation, CA F, gave GST consultancy, compilation engagement for historical financial information and helped in ERP set up along with advisory services to PQR Pvt. Ltd. Mr. F was asked to provide details of the companies as the company, turned out to be a part of a group of companies, involved in money laundering. Contention of Mr. F that he gave only consultancy services and compilation engagement for historical financial information to the company and wasn't supposed to keep any information about the company is not valid as Mr. F should have kept following information in compliance with KYC Norms which are mandatory in nature and shall apply in all assignments pertaining to attestation functions.

In the given case of PQR Pvt. Ltd., a Corporate Entity, Mr. F should have kept following information:

A. General Information

- Name and Address of the Entity
- Business Description
- Name of the Parent Company in case of Subsidiary
- Copy of last Audited Financial Statement

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B. Engagement Information

- Type of Engagement

C. Regulatory Information

- Company PAN No.
- Company Identification No.
- Directors' Names & Addresses
- Directors' Identification No.

16. As per Clause (12) of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated in the following instances and such delegation will not attract provisions of this clause:

(i) Issue of audit queries during the course of audit.

(ii) Asking for information or issue of questionnaire.

(iii) Letter forwarding draft observations/financial statements.

(iv) Initiating and stamping of vouchers and of schedules prepared for the purpose of audit.

(v) Acknowledging and carrying on routine correspondence with clients.

(vi) Issue of memorandum of cash verification and other physical verification or recording the results thereof in the books of the clients.

(vii) Issuing acknowledgements for records produced. Raising of bills and issuing acknowledgements for money receipts.

(ix) Attending to routine matters in tax practice, subject to provisions of Section 288 of Income Tax Act.

(x) Any other matter incidental to the office administration and routine work involved in practice of accountancy.

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In the instant case, Mr. S, the auditor of ABC Pvt. Ltd. has delegated certain task to his articles and staff such as issue of audit queries during the course of audit, issue of memorandum of cash verification and other physical verification, letter forwarding draft observations/financial statements, issuing acknowledgements for records produced and signing financial statements of the company.

Therefore, Mr. S is correct in allowing first four tasks i.e. issue of audit queries during the course of audit, issue of memorandum of cash verification and other physical verification, letter forwarding draft observations/financial statements, issuing acknowledgements for records produced to his staff and articles.

However, if the person signing the financial statements on his behalf is not a member of the institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, Mr. S is wrong in delegating signing of financial statements to his staff.

Conclusion: In view of this, S would be guilty of professional misconduct for allowing the person signing the financial statements on his behalf to his articles and staff under Clause 12 of Part 1 of First Schedule of the Chartered Accountants Act, 1949.

17. Given situation can be visualised in following parts:

(A) **Mr. S used to involve himself in equity research and used to advise his friends, relatives and other known people:** As per the recent decisions taken by the Ethical Standards Board of ICAI, a Chartered Accountant in practice may be an equity research adviser, but he cannot publish a retail report, as it would amount to other business or occupation.

In the given case, though Mr. S is involved in doing equity research and in advising people, it is clear that he does not publish any retail report of his research. Hence, this act of Mr. S shall not make him guilty of professional misconduct.

(B) Mr. S is involved in paper-setting for the Accountancy subject in the school where he studied. He also owns agricultural land and does agriculture activities: As per Clause 11 of Part I of First Schedule of the Chartered Accountants Act and regulation 190A of Chartered Accountants Regulations, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

Further, Regulation 190A mentions the 'Permissions granted Generally' to engage in a certain category of occupations, for which no specific permission of Council is required. Those cases include:

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- Valuation of papers, acting as paper-setter, head examiner or a moderator, for any examination.
- Owning agricultural land and carrying out agricultural activities.

Therefore, in the given case, the activities of Mr. S as a paper-setter and involvement in agricultural activities do not make him guilty of professional misconduct.

(C) Mr. S was discharged insolvent: Disabilities for the Purpose of Membership : Section 8 of the Chartered Accountants Act, 1949 enumerates the circumstances under which a person is debarred from having his name entered in or borne on the Register of Members, If he, being a discharged insolvent, has not obtained from the court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part. Here it may be noted that a person who has been removed from membership for a specified period shall not be entitled to have his name entered in the Register until the expiry of such period.

In addition, failure on the part of a person to disclose the fact that he suffers from any one of the aforementioned disabilities would constitute professional misconduct. The name of the person, who is found to have been subject at any time to any of the disabilities discussed in section 8, can be removed from the Register of Members by the Council.

In the given case, it is clearly stated that Mr. S was discharged insolvent, and he has also obtained from the court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part. Hence, Mr. S has not violated the provisions of Section 8, and he is not debarred from having his name entered in the Register of Members.

18. Restriction on fees based on a Percentage: According to Clause (10) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

However, Regulation 192 exempts Chartered Accountants in practice to charge fees based on a percentage of profits or contingent upon findings or results for professional work for certain professional services.

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Regulation 192 specifically states that in the case of a valuer for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of the property valued.

Conclusion: Consequently, CA Pankaj shall not be deemed to be guilty of professional misconduct, as he is within the permissible scope of charging fees based on a percentage of the property valued.

19. *Disclosure of Client's Information: Confidentiality is one of fundamental principles governing professional ethics. Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949, addresses professional misconduct related to the disclosure of information by a chartered accountant in practice concerning the business of their clients. Such disclosure to any person other than the client, without the client's consent or unless mandated by prevailing law, is considered a breach of conduct. The Code of Ethics emphasizes that this duty continues even after the completion of the assignment, except when disclosure is necessary for the performance of professional duties.*

In the provided case, CA Johny disclosed significant information about his client's business without obtaining the client's consent, believing that it would enhance the audience's understanding of the topic.

Conclusion: Therefore, this action of CA Johny constitutes professional misconduct under Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

20. *As per the Council General Guidelines 2008, under Chapter IX on appointment as statutory auditor a member of the Institute in practice shall not accepts the appointment as a statutory auditor of a PSUs'/Govt company(ies)/Listed company(ies) and other public company(ies) having a turnover of ₹ 50 crores or more in a year and where he accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking. For this purpose, the other work/services include Management Consultancy and all other professional services permitted by Council excluding audit under any other statute, Certification work required to be done by the statutory auditor and any representation before an authority.*

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In the given case, the company offers CA Vaayu, the statutory auditor, an assignment of representation before Income Tax Appellate Tribunal for remuneration of ₹ 1.75 Crores.

Conclusion: In view of the above provision, it would not be misconduct on Vaayu's part if he accepts the assignment of representation before Income Tax Appellate Tribunal for remuneration of ₹ 1.75 crore.

21. *As per Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.*

Provided that nothing herein contained shall be construed as preventing or prohibiting -

(i) Any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice; or

(ii) A member from responding to tenders or enquiries issued by various users of professional services or organisations from time to time and securing professional work as a consequence.

However, as per the Guidelines issued by the Council of the Institute of Chartered Accountants of India, a member of the Institute in practice shall not respond to any tender issued by an organisation or user of professional services in areas of services which are exclusively reserved for chartered accountants, such as audit and attestation services. However, such a restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.

In the given case, Sanjeev & Associates responded to a tender from a PF Office, Chembur, filing quarterly e-TDS returns.

Conclusion: Sanjeev & Associates can respond to the said tender as the tender is open to all the categories i.e. it is open to other professionals along with the Chartered Accountants.

22. *As per Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of the Chartered Accountant unless permitted by the Council so to engage.*

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As per the Guidelines for Corporate Form of Practice, the Council has allowed the members in practice to hold the office of Managing Director, Whole-time Director or Manager of a body corporate within the meaning of the Companies Act, 2013 provided that the body corporate is engaged exclusively in rendering Management Consultancy and Other Services permitted by the Council in pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 and complies with the conditions(s) as specified by the Council from time to time in this regard. The name of the Management Consultancy Company is required to be approved by the Institute and such a Company has to be registered with the Institute.

The members can retain a full-time Certificate of Practice besides being the Managing Director, Whole-time Director or Manager of such management consultancy company. There will be no restriction on the quantum of the equity holding of the members, either individually and/ or along with the relatives, in such a company. Such members shall be regarded as being in full- time practice and therefore can continue to do attest function either in individual capacity or in Proprietorship/Partnership firm in which capacity they practice and wherein they are also entitled to train articled/audit assistants.

In the given case, CA Shubh, a Chartered Accountant specializing in Information Systems Audit and considered an expert in the field, was offered the position of Managing Director by ZX Limited, a management consultancy firm. He accepted the role without obtaining prior permission from the Institute of Chartered Accountants of India

From the above provisions, it can be concluded that the action of CA Shubh is valid.

23. *As per Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty if he does not exercise due diligence or is grossly negligent in the conduct of this professional duties.*

In the given case, Pitch Private Limited requested CA Angad, a practicing Chartered Accountant, to digitally sign the form related to resignation of Mr. Ravi, one of the Director of Pitch Private Limited, along with the copy of Resignation Letter to be uploaded on the website of Registrar of Companies. The signature of Mr. Ravi was simply copied and pasted by another Director of Pitch Private Limited.

CA Angad, without verifying the genuineness of the Resignation Letter, digitally signed the Form and the said form was uploaded on the website of Registrar of Companies.

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Due to forged resignation letter, the resignation of Mr. Ravi from directorship of the Pitch Private Limited had been occurred. It was noted that CA Angad had not taken any step to verify forged signature on resignation letter which anyone would have taken in normal circumstances.

Hence, CA Angad would be held liable for professional misconduct as per Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

24. *In the given situation, Shri Limited, a listed company, has installed pollution control equipment for processing the pollutants to keep the level of pollution below the prescribed standard. The company managed to get pollution certificate by unfair means whereas breach of pollution control laws still continues. For arranging clearance certificate amount of ₹ 18.75 lacs had been incurred unlawfully. CA Gopal, Director Finance, came to know about these matters on review of the same during the period.*

NOCLAR, under Code of Ethics, is applicable on professional accountants in service, and in practice. Among those in practice, it applies to Auditors, as well as professional services other than Audit.

It is applicable to Senior Professional Accountants in service, being employees of listed entities. Senior professional accountants in service ("senior professional accountants") includes directors.

NOCLAR takes into account non-compliance that causes substantial harm resulting in serious consequences in financial or non-financial terms.

As per NOCLAR, in exceptional circumstances, the professional accountant might become aware of an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having first considered whether it would be appropriate to discuss the matter with management or those charged with governance of the company, the accountant shall exercise professional judgment and determine whether to disclose the matter immediately to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach. If disclosure is made, that disclosure is permitted.

CA Gopal, Director-Finance is expected of taking the following action/responses:

- *Obtaining an understanding of the Matter.*
- *Addressing the matter.*

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- *Seeking advice.*
- *Determining whether further action is needed.*
- *Determining whether to disclose the matter to an Appropriate Authority.*
- *Imminent breach.*
- *Documentation.*

25. *Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he engages in any business or occupation other than the profession of Chartered Accountants unless permitted by the Council so to engage.*

Provided that nothing contained herein shall disentitle a Chartered accountant from being a director of a Company, (not being a managing director or a whole-time director), unless he or any of his partners is interested in such company as an auditor.

Ethical Standards Board of ICAI has announced that it is permissible for a member in practice to engage in derivative transactions in his personal capacity but not in professional capacity i.e. for clients. Such engagements in derivatives are not violative of provisions of Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949. Further, members are allowed to transact in equity and currency derivatives. There is no requirement to take permission of Council in this matter.

Therefore, there is no difference if CA Kapila had earned income from currency derivatives. However, in accordance with the announcement of Ethical Standards Board of ICAI, it is not permissible for members in practice to transact in commodity derivative transactions. In such a case, CA Kapila would be held guilty of professional misconduct for engaging in business other than profession of Chartered Accountancy.

26. *Principle of Confidentiality: In terms of subsection 114 of Revised Code of Ethics, a professional accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as a result of professional and employment relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant in the knowledge that the information will not be disclosed to a third party. Nevertheless, the following are circumstances where professional accountants are or might be required to disclose confidential information or when such disclosure might be appropriate:*

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(1) Disclosure is required by law,

(2) Disclosure is permitted by law and is authorized by the client or the employing organisation;

(3) There is a professional duty or right to disclose, when not prohibited by law:

(i) To comply with the requirements of Peer Review or Quality Review of the Institute;

(ii) To respond to an inquiry or investigation by a professional or regulatory body;

(iii) To protect the professional interests of a professional accountant in legal proceedings; or

(iv) To comply with technical and professional standards, including ethics requirements.

In deciding whether to disclose confidential information, professional accountants should consider the following points:

(1) Whether the interests of any party, including third parties whose interests might be affected, could be harmed if the client or employing organization consents to the disclosure of information by the professional accountant;

(2) Whether all the relevant information is known and substantiated, to the extent it is practicable; and

(3) The proposed type of communication, and to whom it is addressed;

(4) Whether the parties to whom the communication is addressed are appropriate recipients.

27. As per Section 2(2)(iv) of the Chartered Accountant Act, 1949 as amended from time to time, a member of the Institute shall be deemed 'to be in practice' when individually or in partnership with Chartered Accountants in practice, or in partnership with members of such other recognized professional as may be prescribed, he, in consideration of remuneration received or to be received, renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice.

As per Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

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However, the Council of the Institute is empowered to permit chartered accountants in practice to engage in any other business or occupation considered fit and proper. Accordingly, the Council formulated Regulations 191 to the Chartered Accountants Regulations, 1988 specifying the activities with which a member in practice can associate himself with or without the permission of the Council. As per Regulation 191 a Chartered Accountant in practice may take up an appointment that may be made by the Central Government or a State Government or a court of law or any other legal authority or may act as a secretary in his professional capacity, provided his employment is not on a salary-cum-full-time basis".

In the instant case, CA Raj, a practicing chartered accountant has been appointed as a "Secretary" in his professional capacity by the Central Government for a metro project for a term of 2 years not on a salary-cum-full-time basis.

Conclusion: In view of above, in the given scenario, CA Raj will not be held liable for misconduct for acceptance of appointment as Secretary in terms of compliance of Regulations 191 read with Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949.

28. *In the given situation, CA R is looking after the audit of TP Limited, a listed company. During the audit, CA R observed that there are a number of notices received from GST Department and Income-tax Department for various issues. Further during plant visit, CA R observed that few child labourers are engaged in some of the activity. In response to the observation made, CA R followed the procedure as envisaged in SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". assuming the provisions of SA 250 and the provisions of NOCLAR (Non-Compliance with Laws and Regulations) under Revised Code of Ethics are one and the same. However, following points indicates that the provisions of SA 250 and NOCLAR (Non-Compliance with Laws and Regulations) under the Revised Code of Ethics are not one and same:*

    (i) SA 250 is applicable only on Audit, and not on other Assurance engagements. However, NOCLAR is applicable on professional accountants in service, and in practice.

    (ii) SA 250 talks of auditor's responsibilities for laws having direct effect on the determination of material amounts and disclosures in the financial statements (such as tax and labour laws); and other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the

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financial statements, but compliance with which may be fundamental to the operating aspects of the business. NOCLAR, while being alike to SA 250 till this point, is further ahead of it in that it takes into account non-compliance that causes substantial harm resulting in serious consequences in financial or non-financial terms.

(iii) SA 250 does not define stakeholders. NOCLAR is related to affect of non-compliance on investors, creditors, employees as also the general public.

(iv) As per NOCLAR, in exceptional circumstances, the professional accountant might become aware of an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having first considered whether it would be appropriate to discuss the matter with management or those charged with governance of the company, the accountant shall exercise professional judgment and determine whether to disclose the matter immediately to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach. If disclosure is made, that disclosure is permitted. This provision is not existent in SA 250.

29. Restriction on Fees based on a Percentage: According to Clause (10) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

However, Regulation 192 allow the Chartered Accountant in practice to charge the fees in respect of any professional work which are based on a percentage of profits, or which are contingent upon the findings or results of such work, in the case of a non-assurance services to non-audit clients, and the fees may be based on a percentage of Tax Demand Reduced.

In the given case, CA Kumar, a practicing Chartered Accountant, provides non-assurance services. He is approached by XYZ Limited, a non-audit client, to file an appeal in Tribunal against Income-tax Demand of ₹10 crore which was added by the CIT(A) and to plead on behalf of XYZ Limited in the matter. CA Kumar offers to accept the case and agrees to charge fees 10% of Tax Demand reduced.

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Conclusion: Therefore, Mr. Kumar will not be held guilty of professional misconduct since he is not providing any assurance services to non-audit clients pursuant to Regulation 192 read with Clause 10 of Part I of First Schedule.

30. ***As per provisions of Council Guidelines for Advertisement, 2008, it is not permissible for members to list themselves with online application based service provider Aggregators, wherein other categories like businessmen, technicians, maintenance workers, event organizers etc. are also listed.***

Further, as per explanation to Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, the government departments, government Companies/ corporations, courts, cooperative societies and banks and other similar institutions prepare panels of Chartered Accountants for allotment of audit and other professional work. Where the existence of such a panel is within the knowledge of a member, he is free to write to the concerned organization with a request to place his name on the panel. However, it would not be proper for the Chartered Accountant to make roving enquiries by applying to any such organization for having his name included in any such panel. It is permissible to quote fees on enquiries being received or respond to tenders from the organizations requiring professional services, which maintain such panel.

Getting registered on GeM portal by members does not appear to amount either to empanelment or listing on Aggregator. In Aggregator, it is the third party which is operating, and not the client itself. GeM is operated by the client itself.

It is a pre-requirement of rendering professional services to the Government departments, as stipulated by them, and be considered as ancillary requirement to providing services to the Government departments. Firms of Chartered Accountants are permitted to register on GeM Portal for rendering professional services as there is no violation of the ethical norms of the Institute in registering on the GeM portal and such registration on the Portal is a pre-requirement for providing services to the Government departments/ organisations.

However, firms should ensure compliance with the tender guidelines issued by the Institute while participating in tender or bid floated through GeM Portal. The ICAI has made an announcement in relation to the above.

31. ***As per section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with the Chartered Accountants in practice or in partnership with members of such other***

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recognised professions as may be prescribed, he, in consideration of remuneration received or to be received, renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice.

Pursuant to section 2(2) (iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services" which, inter alia, includes rendering services of valuation of shares and business and advice regarding amalgamation, merger and acquisition, acting as Registered Valuer under the Companies Act, 2013 read with the Companies (Registered Valuers and Valuation) Rules, 2017. In this regard, such rules qualify Chartered Accountants for valuation of the securities or the financial Assets only and not for the Plant and Machinery. Therefore, valuation of plant and machinery does not form part of Management Consultancy and other services permitted by the council.

Further, in accordance with the resolution passed under Regulation 190A of the Chartered Accountant Regulations, 1988, members in practice are generally permitted for attending classes and appearing for any examination. There is no need to take prior permission of ICAI in this regard. Therefore, it is generally permitted for a member in practice to attend classes and appear for any examination, and accordingly, doing the Registered valuer course would be deemed as permissible.

Hence, keeping in view above and in terms of the provisions of the Chartered Accountants Act, 1949 and Code of Ethics, it is not permissible for a Chartered Accountant in practice to work as an Engineer/ valuer in plant & machinery simultaneously.

32. *Maintenance of Books of Account by a CA in Practice: Chapter V of the Council General Guidelines, 2008 specifies that a member of the Institute in practice or the firm of Chartered Accountants of which he is a partner, shall maintain and keep in respect of his professional practice, proper books of accounts including the following-*

(i) a Cash Book

(ii) a Ledger

Thus, a Chartered Accountant in practice is required to maintain proper books of accounts.

In the instant case, CA Evan does not maintain proper books of accounts and writes the fees received from various clients in notes on his mobile. Notes maintained by him in mobile cannot be treated as books of accounts.

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Hence, CA Evan, being a practicing Chartered Accountant will be held guilty of misconduct for violation of Council General Guidelines, 2008.

33. *Issuing Certificate without having Certificate of Practice: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the Regulations made thereunder or any Guidelines issued by the Council.*

This clause requires every member of the Institute to act within the framework of the Chartered Accountants Act,1949 and the Regulations made thereunder. Any violation either of the Act or the Regulations by a member would amount to misconduct.

In the given case, CA Rahul has issued a certificate in respect of a consumption statement of raw material to the manager of Miskin (P) Ltd., as a Chartered Accountant in practice when he had not even applied for the CoP to the Institute, thereby contravening the provisions of section 6 of the Chartered Accountants Act, 1949.

Therefore, CA Rahul will be held guilty of professional misconduct in terms of Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949 for contravention of provisions of this Act.

34. *Soliciting Clients: As per Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means except applying or requesting for or inviting or securing professional work from another Chartered Accountant in practice and responding to tenders.*

Further, section 140(4)(iii) of the Companies Act, 2013, provides a right to the retiring auditor, to make representation in writing to the company. The retiring auditor has the right for his representation to be circulated among the members of the company and to be read out at the meeting. However, the content of letter should be set out in a dignified manner how he has been acting independently and conscientiously through the term of his office and may, in addition, indicate, if he so chooses his willingness to continue as auditor, if re- appointed by the shareholders.

The proposition of the auditor to highlight contributions made by him in strengthening the control procedures in the representation should not be included in such

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representations because the representation letter should not be prepared in a manner to seek publicity.

Thus, highlighting contributions made by him in strengthening the control procedures, while submitting representation u/s 140(4)(iii) of the Companies Act, 2013 would amount to canvassing or soliciting for his continuance as auditor.

Therefore, CA Lucky will be held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

35. *Failed to Supply Information Called For: In accordance with Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949, a member, whether in practice or not, is considered to be engaged in professional misconduct if he fails to provide the information requested or does not comply with the requirements set forth by the Institute, Council, or any of its Committees, including the Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board, or the Appellate Authority.*

Conclusion: Therefore, in the given scenario, CA Anita has neglected to respond to the Institute's letters seeking confirmation of her appointment date and has not submitted her membership certificate. Consequently, she is deemed to be guilty of professional misconduct as given in Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949.

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