

PAPER
3

**FINAL COURSE
STUDY MATERIAL
GROUP-I**

**ADVANCED AUDITING,
ASSURANCE &
PROFESSIONAL ETHICS
MODULE 2 OF 3**



Board of Studies (Academic)
**The Institute of Chartered
Accountants of India**

(Set up by an Act of Parliament)



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SPECIALISED AREAS

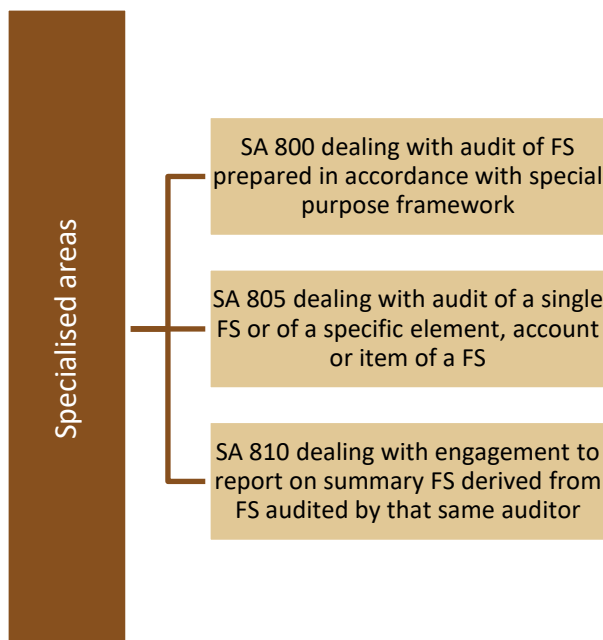


LEARNING OUTCOMES

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* in accordance with 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.

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.

She was wondering whether there was any authoritative pronouncement on the issue. Cursing herself for passing in auditing in CA final exams with bare minimum marks, she turned to the ICAI website and found that SA 800 served her purpose. She also turned to recorded webinars on the issue to gain better clarity.

While turning to webinars, she found that SA 800-899 series dealt with specialised areas. Whereas SA 800 dealt with special considerations in the audit of financial statements prepared in accordance with special purpose framework, SA 805 dealt with special considerations to an audit of a single financial statement or of a specific element, account or item of a financial statement. Although she had read about elements of financial statements, “single financial statement” was a new term 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 whiff of fresh breeze- She had imbibed many new things and was raring to apply these practically.



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: -

- | |
|--|
| <ul style="list-style-type: none"> SA 800 deals with special considerations applicable in respect of the audit of financial statements prepared in accordance with the special purpose framework. |
| <ul style="list-style-type: none"> 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. |
| <ul style="list-style-type: none"> 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. |

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

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 but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

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.

Examples of Special purpose frameworks are: -

- The cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested 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.

Special purpose framework is to be distinguished from general purpose framework. A financial reporting framework designed to meet the common financial information needs of a wide range of users is known as “General purpose framework” whereas a financial reporting framework designed to meet the financial information needs of specific users is known as “Special purpose framework.”

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.

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 purpose financial statements, however, those judgments are based on a consideration of the financial information needs of the intended users.

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.

Revised SA 700 deals with the form and content of the auditor's report. 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.

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 financial statements on public record. 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.

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.

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 "Other 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.



3. SA 805-SPECIAL CONSIDERATIONS—AUDITS OF SINGLE FINANCIAL STATEMENTS AND SPECIFIC ELEMENTS, ACCOUNTS OR ITEMS OF A FINANCIAL STATEMENT

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. SA 805 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 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 group engagement team for purposes of an audit of group financial statements.

The objective of the auditor, when applying SAs, in such an audit, is to address appropriately the special considerations that are relevant to the 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.

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

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 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. 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.

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

(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 element. 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 notes and 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.

3.6 Forming an Opinion and Reporting Considerations

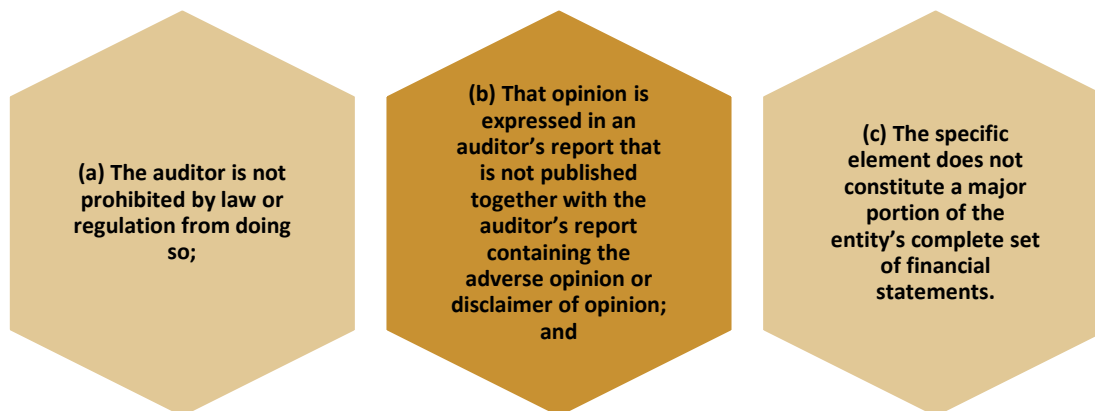
When forming an opinion and reporting on a single financial statement or on a specific element of a financial statement, the auditor shall apply the requirements in Revised SA 700, adapted as necessary in the circumstances of the engagement.

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.

An audited single financial statement or an 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 a 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.

- ❖ If the opinion in the auditor's report on an entity's complete set of financial statements is modified, or that report includes an Emphasis of matter paragraph or other matter paragraph, the auditor shall determine the effect that this may have on the auditor's report on a single financial statement or on a specific element of those financial statements. When deemed appropriate, the auditor shall modify the opinion on the single financial statement or on the specific element of a financial statement, or include an Emphasis of matter paragraph or other matter paragraph in the auditor's report, accordingly.
- ❖ 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 that forms part 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:



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.

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.

Even when the modified opinion on the entity's complete set of financial statements, Emphasis of matter paragraph or Other matter paragraph does not relate to the audited financial statement or the

audited element, the auditor may still deem it appropriate to refer to the modification in an Other matter paragraph in an auditor's report on the financial statement or on the element because the auditor judges it to be relevant to the users' understanding of the audited financial statement or the audited element or the related auditor's report.

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.

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 audit of trade receivables appearing in above financial statements. Can he accept such engagement? Discuss brief outline of his audit approach in such a situation.

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

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.

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:

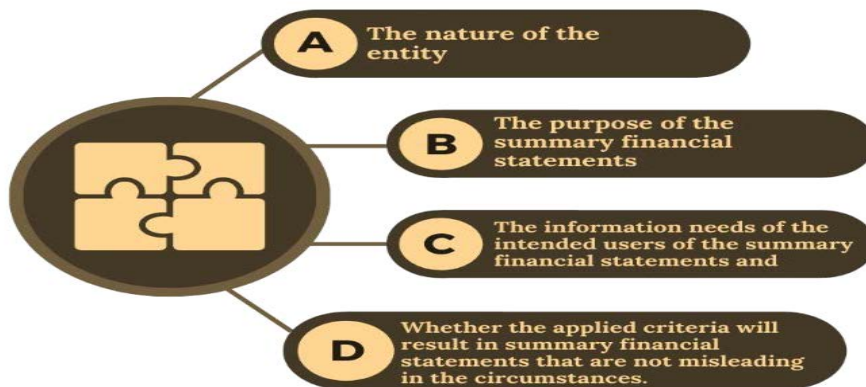
- (a) Determine whether the applied criteria are acceptable.

Applied criteria refer to the criteria applied by management in the preparation of the summary financial statements. Management is responsible for the determination of 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.

FACTORS AFFECTING AUDITOR'S DETERMINATION OF THE ACCEPTABILITY OF THE APPLIED CRITERIA



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

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

- 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.

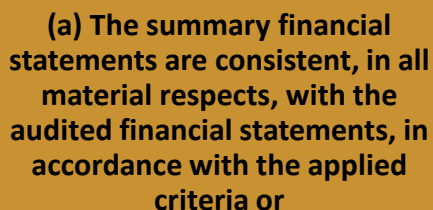
4.3 Nature of Procedures to be Performed by Auditor

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:

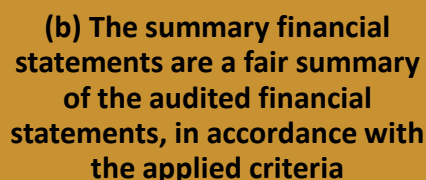
- (a) Evaluate whether the summary financial statements adequately disclose their summarised nature and identify the audited financial statements.
- (b) When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:
 - (i) From whom 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.

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:

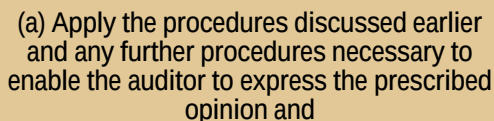


(a) The summary financial statements are consistent, in all material respects, with the audited financial statements, in accordance with the applied criteria or

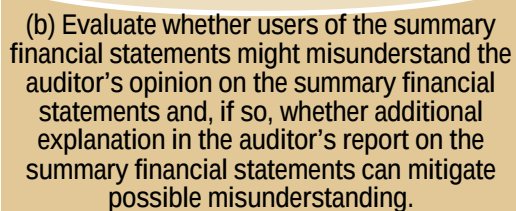


(b) The summary financial statements are a fair summary of the audited financial statements, in accordance with the applied criteria

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.

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) An introductory paragraph:

An Introductory Paragraph

(i) Identifies 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 other information, 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 to identify the summary financial statements to which the auditor's report relates.

(ii) Identifies the audited financial statements

(iii) Refers to the auditor's report on the audited financial statements, the date of that report, and, in cases other than where audited financial statements contain modified opinion, emphasis of matter paragraph and other matter paragraph, the fact that an unmodified opinion is expressed on the audited financial statements;

(iv) 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, 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; and

(v) 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 is not a substitute for reading the audited financial statements.

- (d) 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.
- (e) A statement that the auditor is responsible for expressing an opinion on the summary financial statements based on the procedures required by this SA.
- (f) A paragraph clearly expressing an opinion.
- (g) 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.
- (h) The date of the auditor's report

The auditor shall date the auditor's report on the summary financial statements no earlier than:

(i) The date on which the auditor has obtained sufficient appropriate evidence on which to base the opinion, including evidence that the summary financial statements have been prepared and those with the recognised authority have asserted that they have taken responsibility for them; and

(ii) The date of the auditor's report on the audited financial statements.

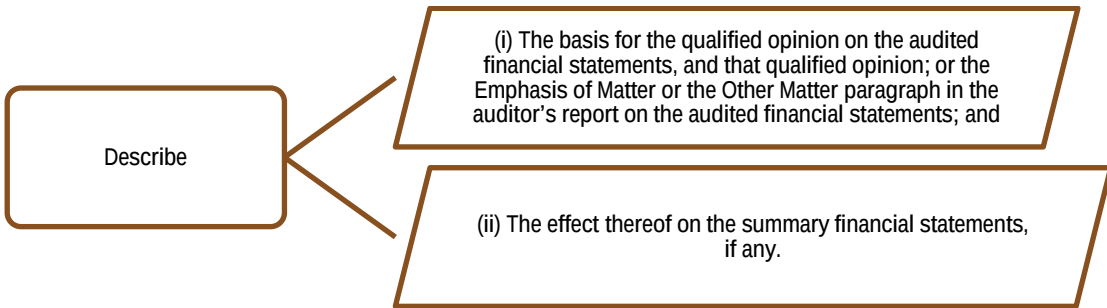
- (i) The place of signature.

4.6 Modifications to the Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Audited Financial Statements

When the auditor's report on the audited financial statements contains a qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph, but 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, also contain followings: -

- (a) State that the auditor's report on the audited financial statements contains a qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph; and
- (b) Describe:



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, additionally: -

(a) State that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion;

(b) Describe the basis for that adverse opinion or disclaimer of opinion; and

(c) State that, as a result of the adverse opinion or disclaimer of opinion, 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

Comparatives in the audited financial statements may be regarded as corresponding figures or as comparative financial information. 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.

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 Other Information in Documents Containing Summary Financial Statements

The auditor shall read the other information included in a document containing the summary financial statements and related auditor's reports to consider whether there is a material inconsistency between the other information and the summary financial statements. If the auditor identifies a material inconsistency, the auditor shall determine whether the summary financial statements or the other information needs to be revised. If, the auditor becomes aware that the other information needs to be revised, the auditor shall discuss the matter with management.

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 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

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.

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)**

<i>Liabilities</i>	<i>Smart investment equity and debt fund</i>	<i>Smart investment equity savings fund</i>
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)

<i>Income</i>	<i>Smart investment equity fund and debt</i>	<i>Smart investment equity fund savings</i>
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: -

- Given the above extract of abridged financial statements and description, which of the following statements is most appropriate?*
 - The auditor may presume that criteria applied by the Board of Trustees in the preparation of the abridged financial statements are acceptable.
 - The auditor cannot presume that criteria applied by the Board of Trustees in preparation of abridged financial statements are acceptable.
 - 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.
 - The auditor is duty bound to accept the criteria applied by the Board of Trustees in the preparation of abridged financial statements.
- 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.
 - (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.
- (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.
- 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.

- 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 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 unmodified opinion in respect of trade receivables? If so, discuss those circumstances.*
2. *List out few factors affecting auditor's determination of the acceptability of the applied criteria before accepting audit of summary financial statements.*
3. *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, meaning of special purpose framework.*
4. *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?*

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 "Other 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 statements prepared in accordance with special purpose framework is also offered audit of trade receivables appearing in above financial statements which relates to audit of element of financial statements prepared in accordance with 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
 - (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 4.2.
- 3. Refer to Para 2.1.
- 4. Refer to Para 4.6.

[illegible]

RELATED SERVICES

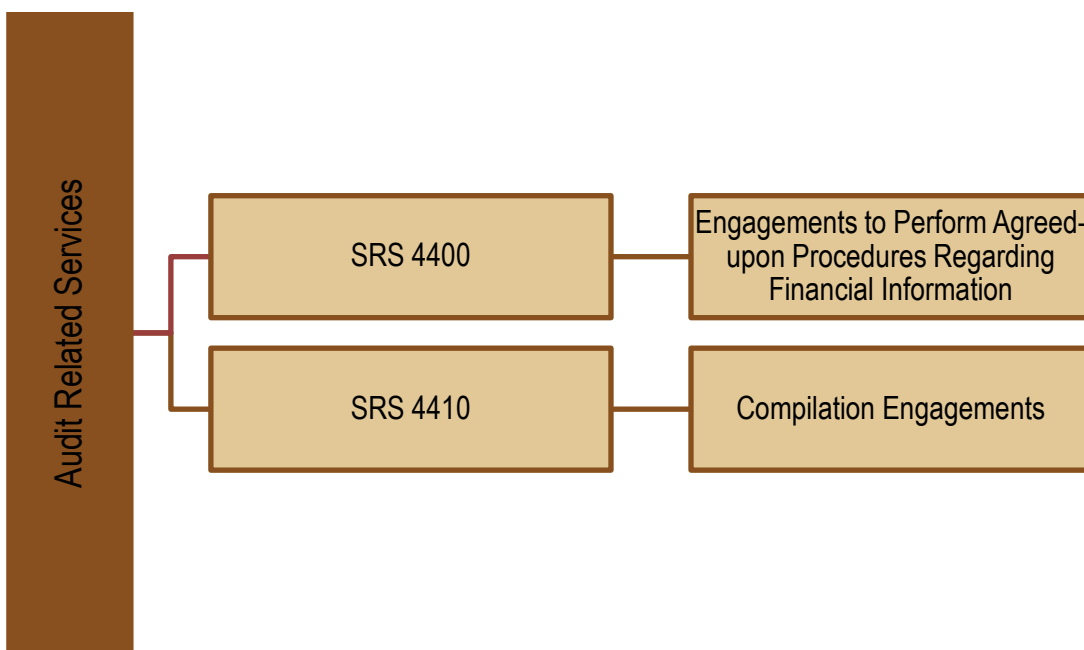


LEARNING OUTCOMES

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.

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.

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, 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 the 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

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.

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

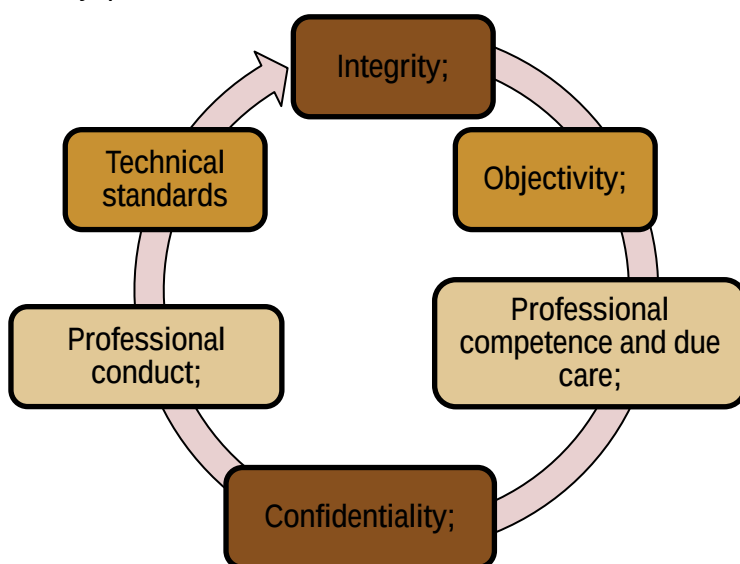


Comparison of such statements or confirmations to the amounts in trial balance

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.

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

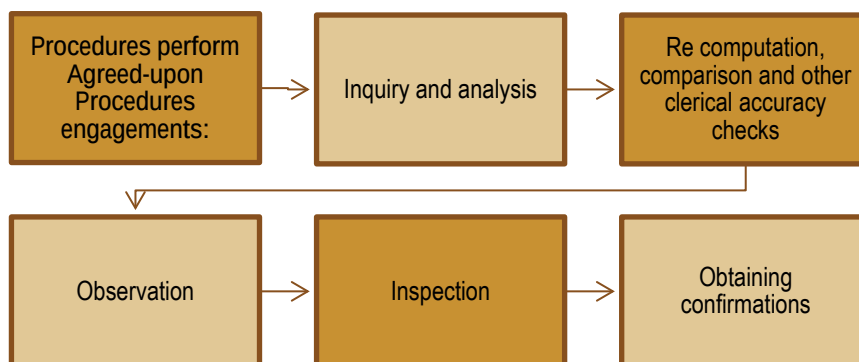
The auditor should plan the work so that an effective engagement will be performed.

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.

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
(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 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 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.

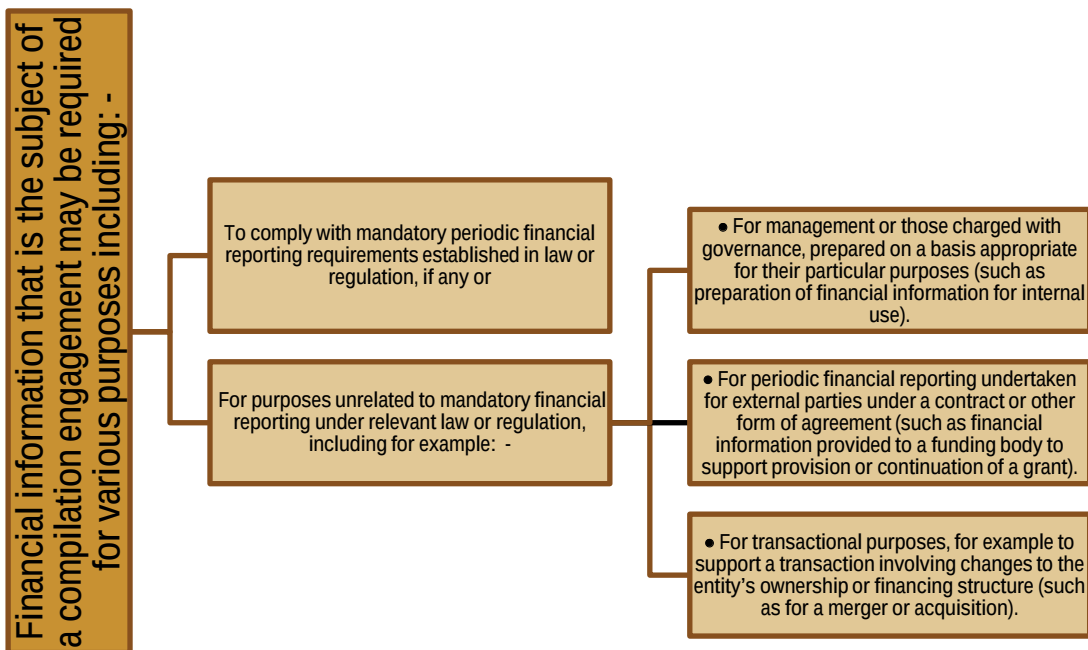
It applies to compilation engagements for historical financial information. Compilation engagements for financial information other than historical financial information, and compilation engagements for non-financial information can be performed under this Standard after necessary adaptation.

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.

3.1 Objectives in accordance with SRS 4410

The practitioner's objectives in a compilation engagement under this SRS are to: -

Objectives in a Compilation Engagement to: -

Apply accounting and financial reporting expertise to assist management in the preparation and presentation of financial information

Report in accordance with the requirements of this SRS.

(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.

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: -						
The responsibilities of management for <table><tr><td>(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</td><td>(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</td><td>(iii) The accuracy and completeness of the records, documents, explanations and other information provided by management for the compilation engagement and</td><td>(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</td></tr></table>				(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
(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.

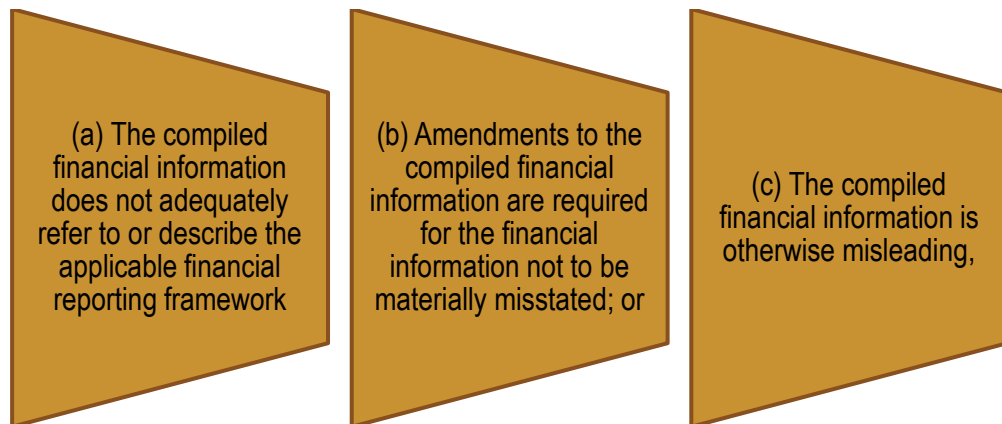
3.5 Performing the Engagement

- 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: -



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.*

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: -	
(i) Describes the purpose for which the financial information is	(ii) Draws the attention of readers of the report to the fact that the financial

prepared and, if necessary, the intended users, or contains a reference to a note in the financial information that discloses this information and	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.

TEST YOUR UNDERSTANDING 2

During the course of performing a compilation engagement in accordance with SRS 4410, it becomes known to you that 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 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, 2023. 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.

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.

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 finalized 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

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 ethical requirements of 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 ?

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
 - 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 client's claim has been repudiated and no appeal has been preferred, it is a loss for the client and should be dealt 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.
3. Refer to Para 1.
4. Refer to Para 3.9.
5. Refer to Para 3 and Para 3.5.

[illegible]

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.

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?

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 the 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:

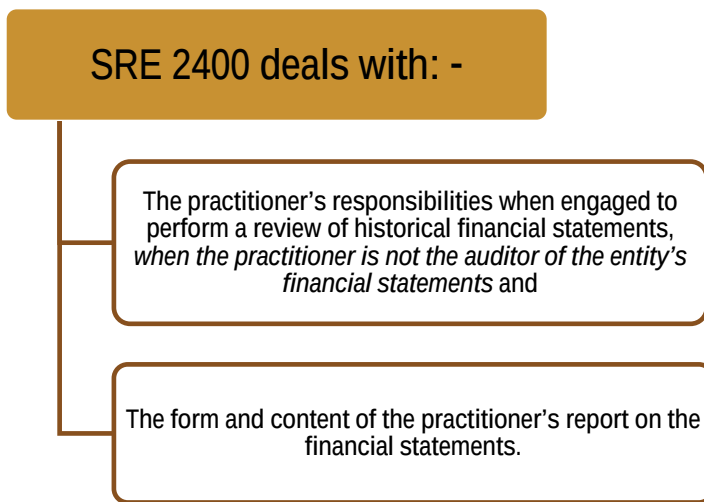
<i>Standards on Review Engagements</i>	
•	SRE 2400 Engagements to Review Historical Financial Statements
•	SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity

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

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.

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:

(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

	Acceptability of financial reporting framework applied in preparation of financial statements.
	Agreement of management in acknowledging and understanding its responsibility for preparation of financial statements and internal control.
	Providing access to all information to the practitioner for the purpose of review and unrestricted access to persons within the entity.

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.

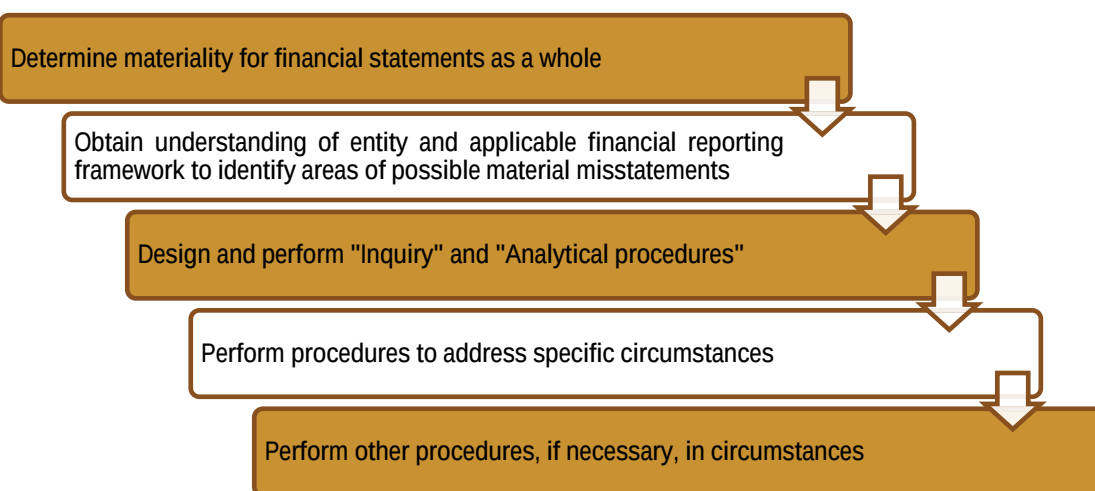
2.4 Agreeing to the Terms of Engagement

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

is the same regardless of the level of assurance obtained by a practitioner as the basis for expressing the conclusion on the financial statements.

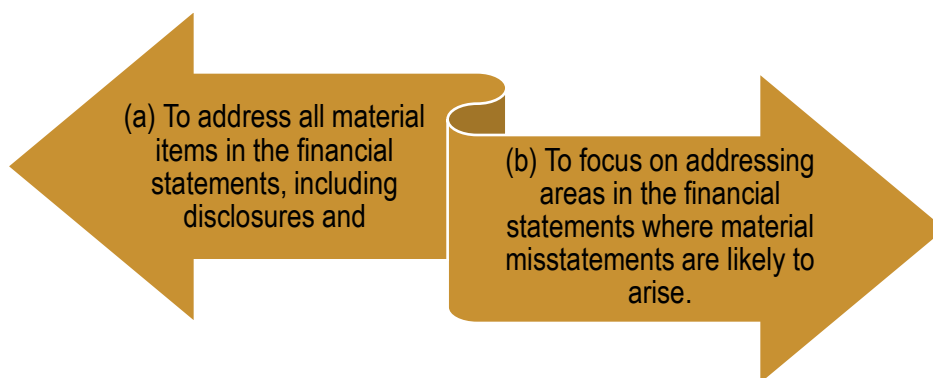
The practitioner shall revise materiality for the financial statements as a whole in the event of becoming aware of any information during the review that would have caused the practitioner to have determined a different amount initially.

(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.

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.

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 scepticism 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

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.

- (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.

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.

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 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

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;

(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.

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

- (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: -

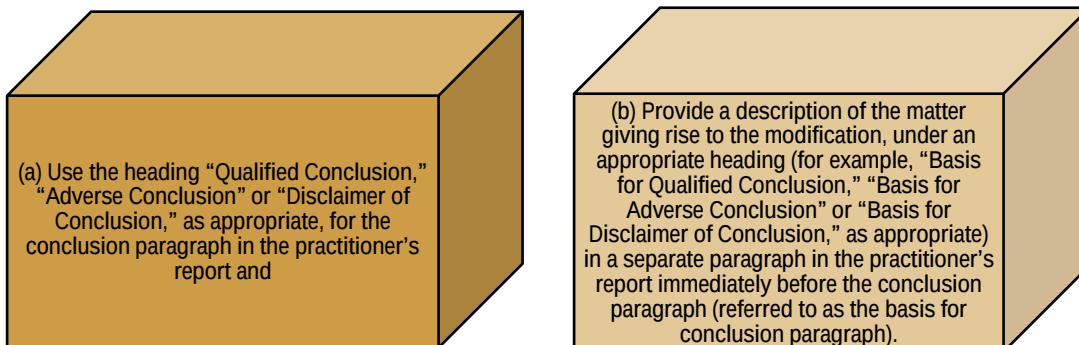
- (a) *"Based on our review, nothing has come to our attention that causes us to believe that the financial statements do not give a true and fair view (or do not present fairly, in all material respects), in accordance with the applicable financial reporting framework," (for financial statements prepared 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.

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) <i>"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</i> |
| (b) <i>"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).</i> |

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:

- (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.

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.

(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

- (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: -

- (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."

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:

- (a) Who performed the work and the date such work was completed and
- (b) Who reviewed the work performed for the purpose of quality control for the engagement, and the period and extent of the review.

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.

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

<i>Audit</i>	<i>Review</i>
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 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.

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 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 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.
- 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 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.
- ◆ 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.

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:

- 
- (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.

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.

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 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.
(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.

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.

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 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.

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 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 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 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 CFO and 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, 2022 ("the Statement"), being submitted by the Company pursuant to the 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 XXXXXXXXXXXX.
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 XXXXXXXXXXXXXXXXXXXXXXXXXXXX.
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.
 - (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.

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.

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 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 quarterly review of financial statements of company in terms of regulatory requirements. He is already well-versed with business of company and has deep understanding of the company. Discuss, any 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 28.7.2022 for financial results of a company for quarter ending 30.6.2022. Describe his responsibility, if any, for events occurring from 1.7.2022 till date of review report in accordance with SRE 2410.

Answers to Test Your Understanding

1. The above financial statements are prepared in accordance with special purpose framework in accordance with requirements of a contract. Financial statements prepared in accordance with 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:

- 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 fire, there is massive disruption in 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.
- 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.

[illegible]

PROSPECTIVE FINANCIAL INFORMATION AND OTHER ASSURANCE SERVICES

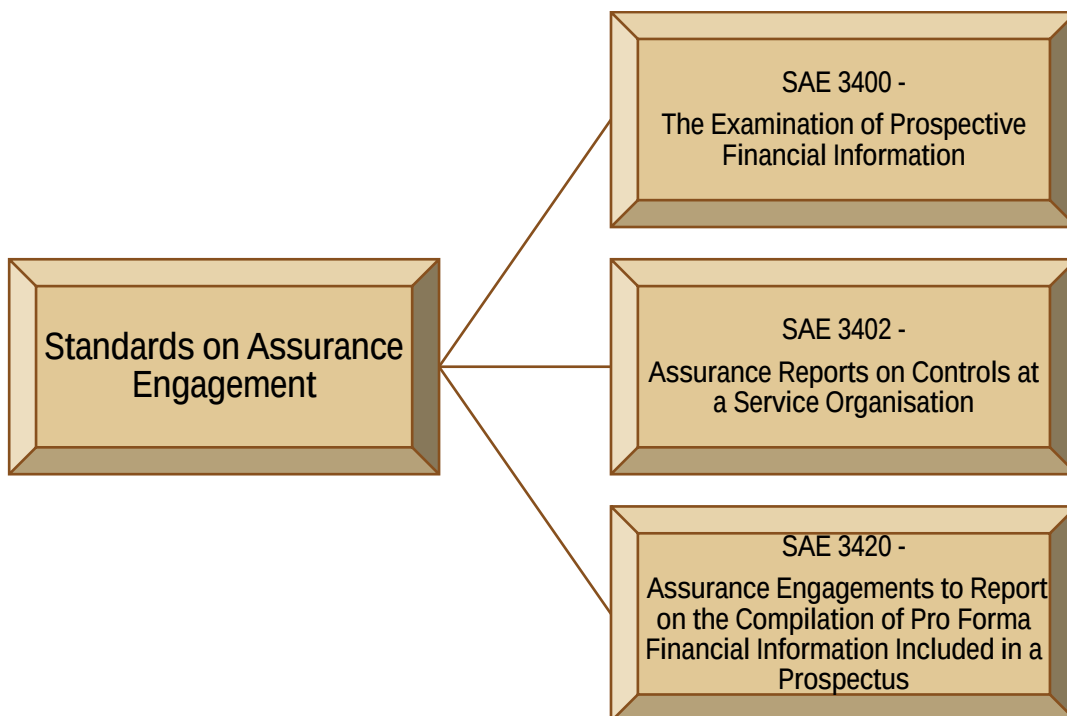


LEARNING OUTCOMES

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.

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.

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, it would also be looked into whether such information is consistent with past financial statements and uses appropriate accounting principles. He started ground work 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.

For example - 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.

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.)

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 a X Ltd 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.

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.

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.

While examining prospective financial information, principles laid down in other Standards on Auditing should be applied to the extent practicable.

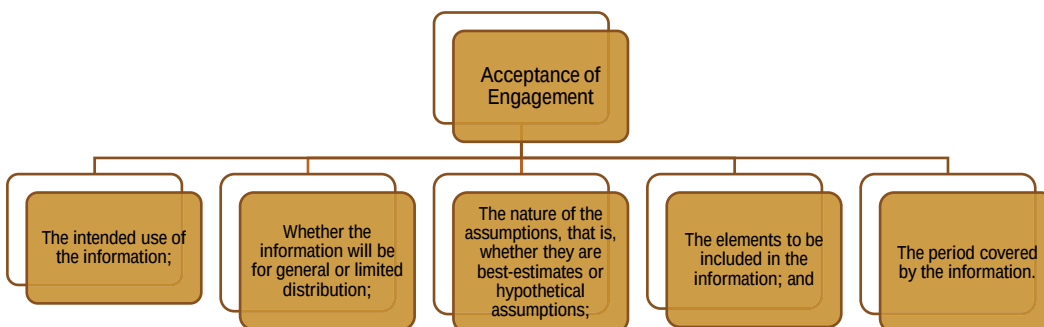
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2.6 Acceptance of Engagement: Precautions to be taken by Auditor Before Accepting such an Engagement

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

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: -

(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

(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.

(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
(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.

- 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.

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.

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.

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 (<i>or in the case of a type 1 report, as at a specified date</i>)
(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 (<i>or in the case of a type 1 report, as at a specified date</i>)
(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;	(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:	(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	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 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

(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

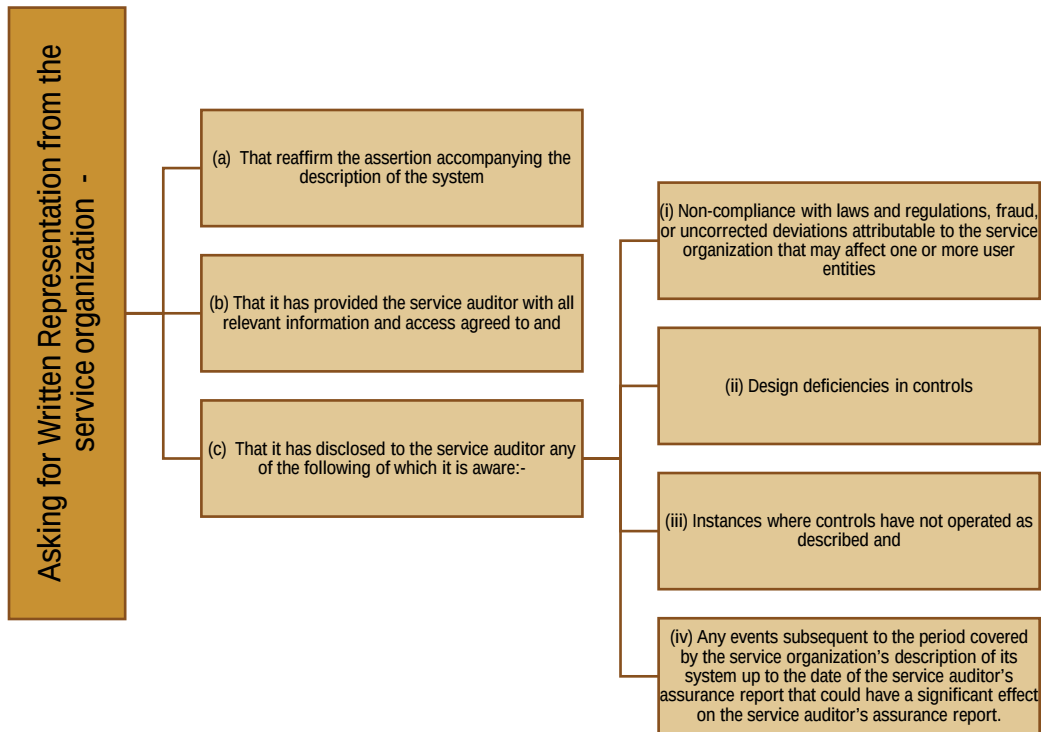
system will be suitable and available to user entities and their auditors and the scope of the engagement and the service organization's description of its system will not be so limited that they are unlikely to be useful to user entities and their auditors.

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

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.

- (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

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.

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:

- The nature, timing, and extent of the procedures performed to comply with this SAE and applicable legal and regulatory requirements
- The results of the procedures performed, and the evidence obtained and
- Significant matters arising during the engagement, and the conclusions reached thereon and significant professional judgments made in reaching those conclusions

TEST YOUR UNDERSTANDING 2

Bansi Group is a leading institution running prestigious post graduate 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 SA 3402?



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

SA 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 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.

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 SA 3420

The objectives of the practitioner in accordance with SA 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.

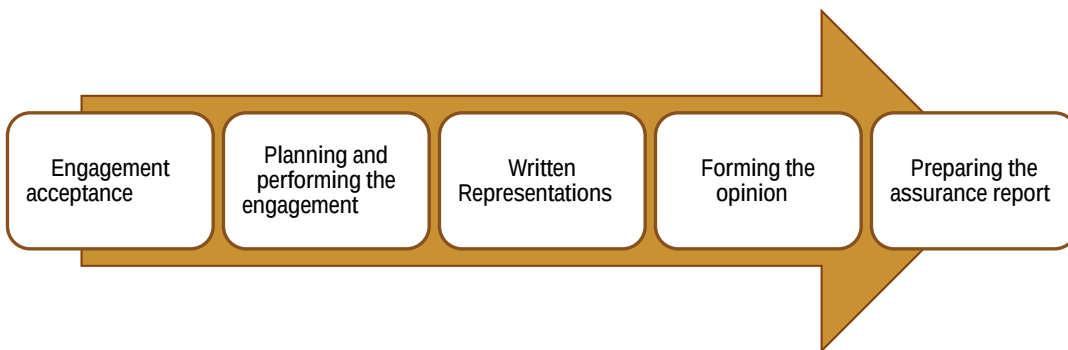
4.3 Nature of the Practitioner's Responsibility

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

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

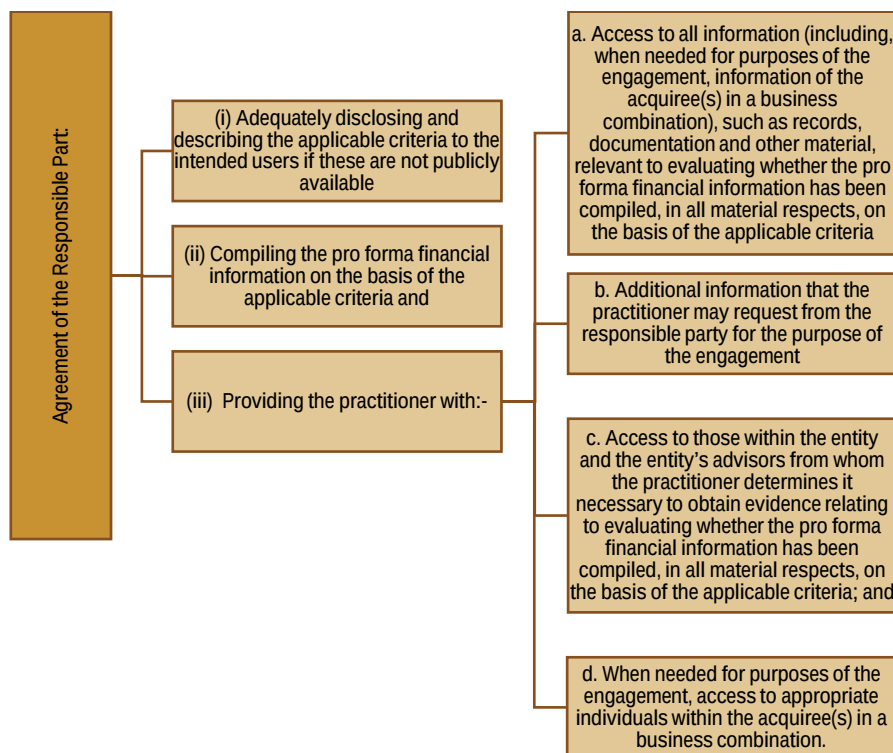


4.4.1 Engagement Acceptance

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

- (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:



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.

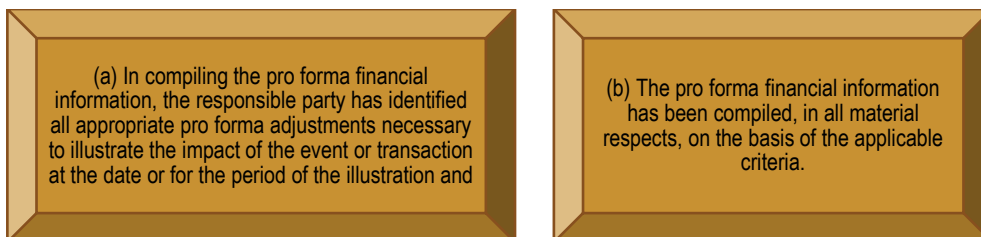
In relation to unadjusted financial information, Pro forma adjustments include:

- (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.

4.4.3 Written Representations

The practitioner shall request written representations from the responsible party that:-



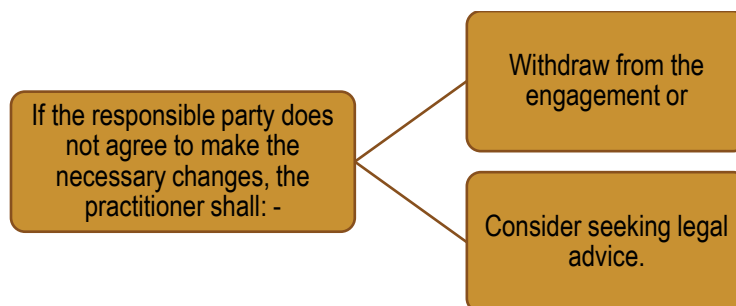
4.4.4 Opinion

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.



(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.

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

- (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: -

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 a prospectus. In light of SAE 3420, what factors you will consider regarding the company acknowledging and understanding its responsibility in this matter before accepting engagement?

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 2023 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

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. *What should be language of such an unmodified assurance report regarding underlying assumptions?*

- (a) Positively worded to suggest assumptions are a reasonable basis.
- (b) Negatively worded to suggest assumptions are not on a reasonable basis.
- (c) Neither positively worded nor negatively worded about assumptions.
- (d) Depends upon the professional judgment of the Chartered Accountant.

4. *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.

5. 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.

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.
- SA 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.
- SA 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.*

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.

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 Income Tax Act 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
- 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. (b)
- 4. (c)
- 5. (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.

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DIGITAL AUDITING AND ASSURANCE

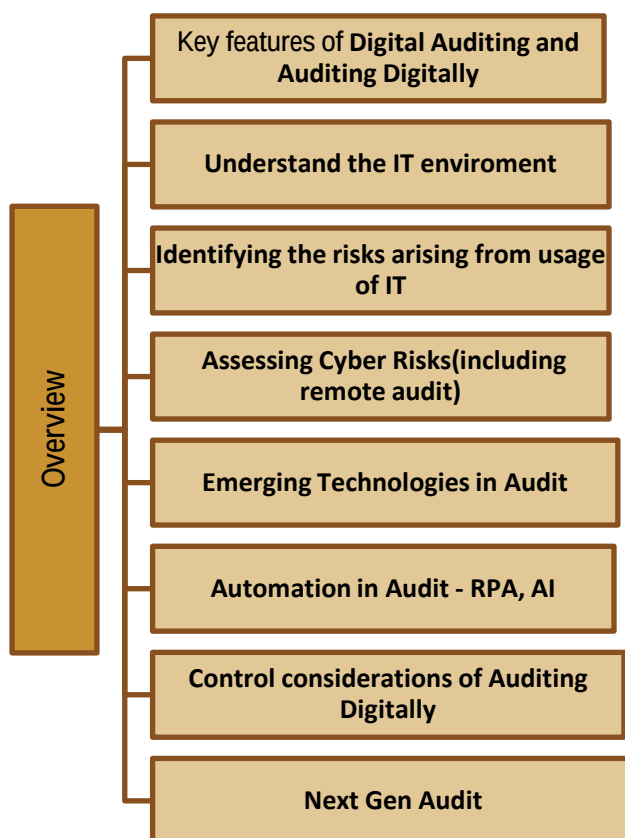


LEARNING OUTCOMES

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.

CHAPTER OVERVIEW



CA M woke up on a leisurely Sunday morning to find a report in his favourite pink newspaper about ICAI and Indian Banks Association plans to develop a balance confirmation portal. The report further indicated that such a proposed common platform would ensure authenticated balance confirmations by auditors directly from banks. "Auditing digitally improves efficiency and quality of audits"- he thought. Wondering that besides ushering in an era of transparency, such initiatives are likely to enhance efficiency and reduce costs. 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 is imminent requirement. Use of data analytics, artificial intelligence and robotics

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 coded 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.



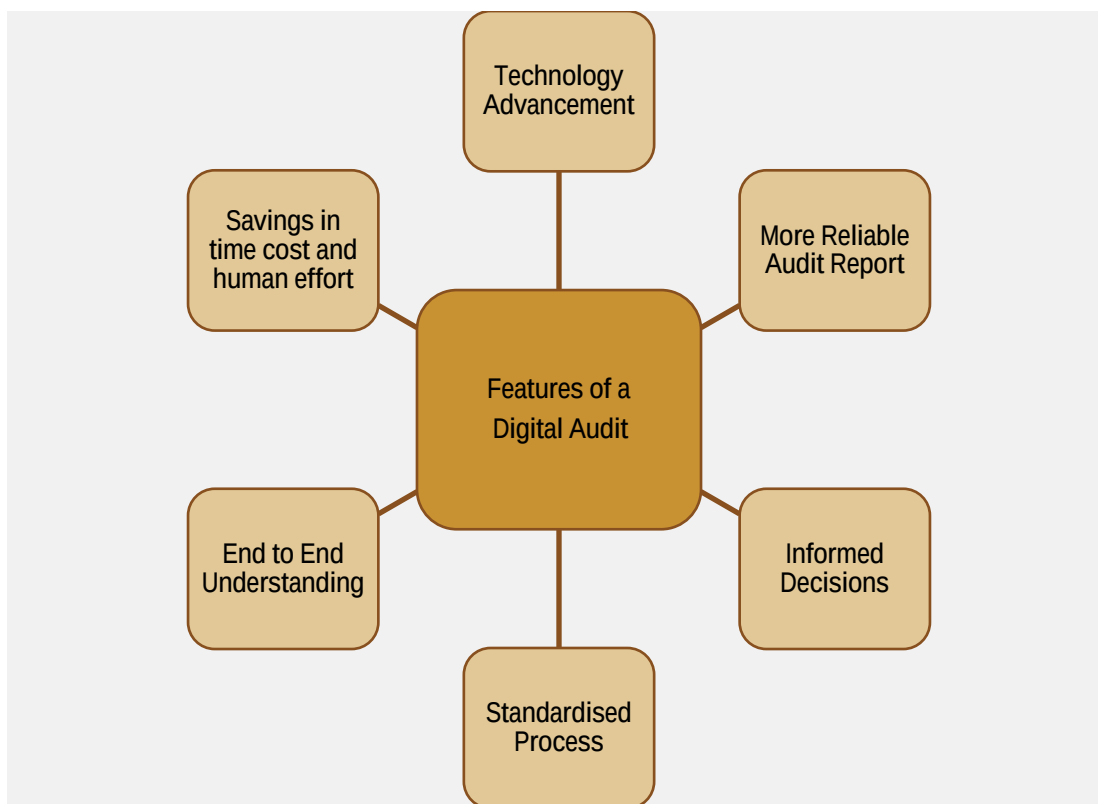
1. DIGITAL AUDIT

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 organization 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 auditee to make informed decisions.



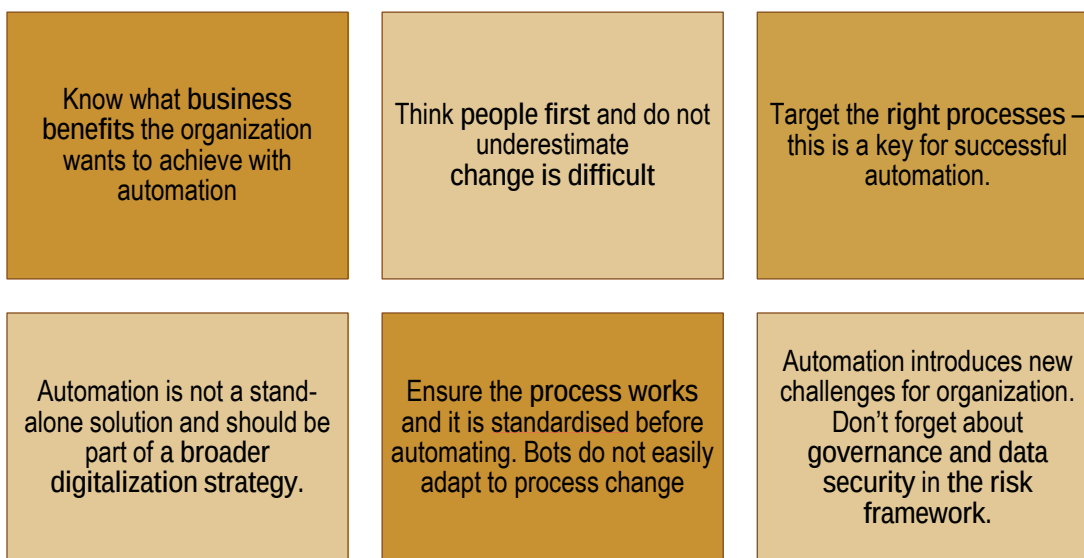
1.3 Advantages of Digital Audit

- (i) **Enhanced Effectiveness & Efficiency:** Increased efficiency is one of the key benefits of digital audit. With the use of tools and automation techniques, auditee 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 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:



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 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).



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 the 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 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.

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 helps 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:

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 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 help 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 techniques are using robotics and automation for data gathering activities, use of data analytics for planning and budgeting 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).
- 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

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
 - 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.
- 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 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 use 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 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. A 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 nodes, 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, 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.

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:

Access Security Objective: To ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives	• Access requests to the application are properly reviewed and authorized by management • Access of terminated user is removed on a timely basis • Access rights to applications are periodically monitored for appropriateness • Transactions of administrative and sensitive generic IDs are monitored • Security policies and procedures are maintained • Access to operating system and database is restricted.
Program Change Objective To ensure modified systems continue to meet financial reporting objectives	• Change Management policy and procedures are maintained. • Development, testing and production environments are segregated for changes to application configurations • Changes are adequately tracked and recorded. • Changes to application configurations are adequately tested and approved before being migrated into production • Emergency changes are approved. • Segregation of duties is maintained between developer and implementor.
Data Centre and network operations Objective To ensure production systems are appropriately backed up to meet financial reporting objectives	• Policies and procedures for data back and recovery is maintained. • Data is appropriately backed up and recoverable • Restoration testing is performed • Monitoring and compliance of service level agreements. • Batch job scheduled are monitored for failures and access is restricted.

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. Auditor should scope in ITGCs to tests when there are IT dependencies identified in the system. If the controls around IT environment are not implemented or operating effectively it will result in not relying on ITGCs which means the IT dependencies could not 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:

- **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.
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.

- **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.

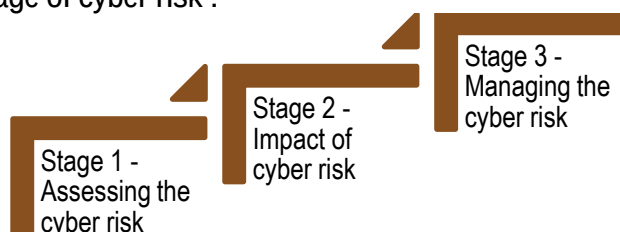
Type	Description
Domain Spoofing	Domain spoofing is a form of phishing where an attacker impersonates a known business or person with fake website or email domain to fool people into the trusting them. Typically, the

	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.

- **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:

Following are 3 Stage of cyber risk :



1. **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 disclosure of information theft and frauds.

2. 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 an 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

3. Stage 3 - Managing the 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.

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 reviews 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 reviews 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.

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. 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.

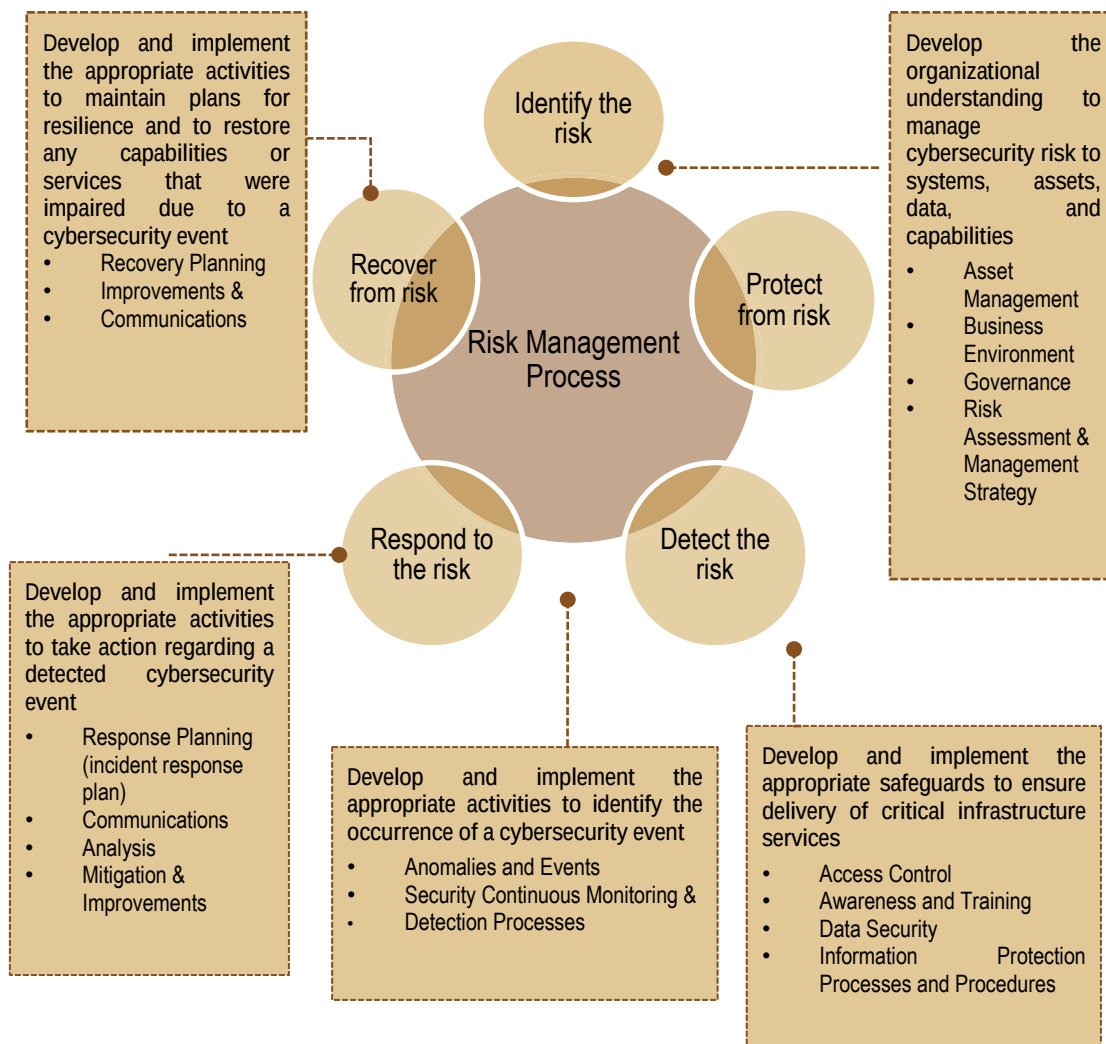
The security incident response plan helps in analysing the impact and severity of the attack and helps the organisation in taking the appropriate actions. Management should assess Litigation costs, Regulatory investigation costs and Remediation costs as a part of mitigation process and improvement management 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.



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?

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 a strong and updated internal controls to ensure they are covered from cyber risks:

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 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.

- 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

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 connection. 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 provide 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

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 accesses 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.

Audit analytics helps:

- To discover and analyze 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

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.



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.

Name	File Name	Prepared by	Reviewed by	Tags	Due Date
WORKING PAPERS					
FINANCIAL STATEMENTS					
1.1.2 Consolidating Financial Statements	Australia Investments Ltd RI	RI	04/18/2017	Deliverable	05/18/2017
1.1.3 Excel Connector Linked Balance Sheet.xls	BS.xls	RI	04/19/2017	Deliverable	05/26/2017
1.2.A Balance sheet - draft by Account No				Draft	
1.2.M Balance sheet - draft by Map No					
1.3.A Income statement - draft by Account No					
1.3.M Income statement - draft by Map No					
1.4.A Statement of cash flow - draft by account					
1.4.M Statement of cash flow - draft by Map No					
1.5 Draft financial by leadsheet	Australia Investments Ltd				
1.6 Draft by leadsheet Current/Prior/Budget	Australia Investments Ltd				
1.7 Draft by leadsheet Five years	Australia Investments Ltd				
1.8 Balance Sheet - map number					
1.9 Income Statement - map number					
1.10 Statement of Cash Flow - map number					
1.11 Balance Sheet by Group 2					
1.12 Client's 3 Year Balances.csv	Client's 3 Year Balances.csv				
1.13 External document link placeholder					
INCOME TAX RETURNS					
2.1 Federal tax return	Federal tax return.pdf				
2.2 Provincial/State tax returns	Provincial/State tax return				
2.3.CAN Trial balance grouped by GIFI					
2.3.USA Tax Reconciliation					

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.

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 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.

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 transactions 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 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 to liability 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 organisation has the necessary data management processes and 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 contains 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 includes 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.

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.

(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. 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.
- 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.

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 given below:

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 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.	Identify the cash price equivalent and the present value of deferred payments for PPE items.	Calculate the present value of deferred payments using an appropriate discount rate.	Disclose the cash price equivalent and the present value of deferred payments for PPE items.	Establish internal controls over the identification and calculation of cash price equivalent and present value of deferred payments for PPE items.	Verify the cash price equivalent 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 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.	Identify the borrowing costs and the qualifying assets for PPE items.	Allocate the borrowing costs to qualifying assets based on a rational and consistent basis.	Disclose the borrowing costs and the qualifying assets for PPE items.	Establish internal controls over the identification and allocation of borrowing costs and qualifying assets for PPE items.	Verify the borrowing costs and qualifying assets for PPE items by 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,

					constructed assets.	analytical procedures, etc.
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 item can be measured reliably. Derecognize the carrying	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.

	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.



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
- 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.

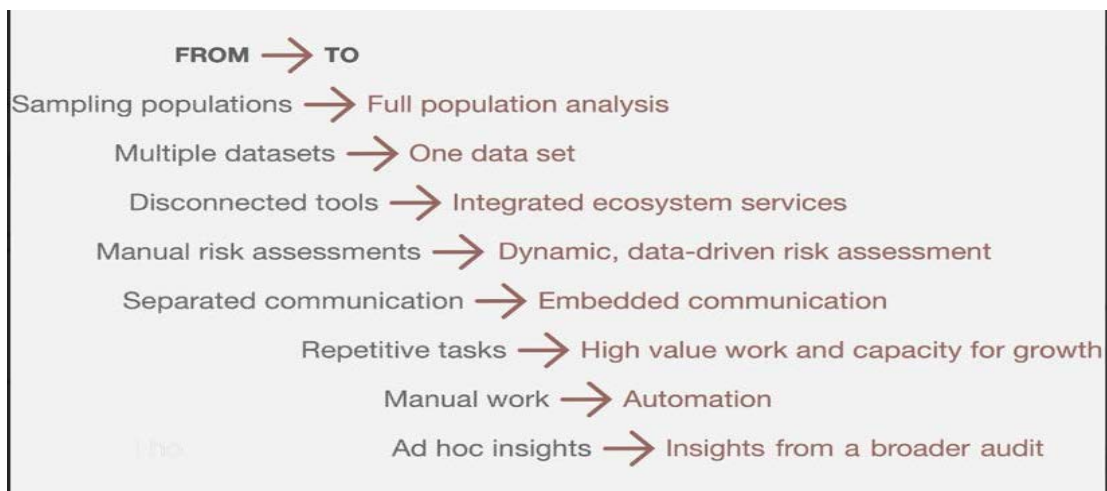
TEST YOUR UNDERSTANDING 3

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.

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.
- 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 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.

Integrated Case Scenario:

Consider the following five situations: -

[A] Safe Health Insurance Limited is a company working in field of health insurance sector. It is now using a claim management system where incoming claims can be immediately identified on the website itself. A form is issued to the customer who signs it. The details are verified by the system against data present in it. Such a system has allowed faster processing of claims, error-free data validation and increased customer satisfaction.

[B] During the course of audit of a company, it is noticed that a cyber attack took place on the data in which files were encrypted and computers got locked. The hacker then demanded a booty for decryption of files which was to be paid in bitcoins.

[C] CA X, auditor of a company, is looking into cyber security risks of the company. He is making inquiries regarding processes and controls relating to privileged account access, patch management program, vendor risk management program. He has also performed external network penetration testing.

[D] "Verificatory" is an entity which can stamp e-mails or any files. It simplifies certifying of e-mails by just e-mailing to them to an e-mail specifically created for each customer. Many law firms can use this service to certify documents. The information is secured by networks of thousands of computers distributed across the globe. It uses cryptographic algorithms. The information can be verified from anywhere in the world. Its hashing and time stamping is of significant evidentiary value.

[E] CA X is planning for audit of an entity. The timelines are agreed in a meeting with key management person on an electronic meeting platform. The entity also agrees to provide data electronically. Video-conference meetings are to be held from time to time with the client.

Keeping in view above situations, answer the following questions: -

- 1 In respect of situation regarding working of insurance company in health insurance sector, which of following technologies has likely been used?
 - (a) Internet of things
 - (b) Data analytics
 - (c) Robotic process automation
 - (d) Power BI
2. Which type of cyber attack is referred to situation described in para [B]?
 - (a) Ransomware
 - (b) Trojan
 - (c) Denial of service attacks
 - (d) Fileless Malware
3. In situation described at [C] above, which is not part of risk assessment procedures to assess cyber security risks?
 - (a) Making inquiries regarding processes and controls relating to privileged account access
 - (b) Making inquiries regarding processes and controls relating to patch management program
 - (c) Making inquiries regarding processes and controls relating to vendor risk management program
 - (d) Performing external network penetration testing
4. The kind of services being provided by an entity described at [D] above, are example of use of: -
 - (a) Blockchain technology
 - (b) Internet of things

- (c) Ethical hacking
 - (d) Cyber attestation
5. Which of following is false in an audit described at para [E]?
- (a) The opportunity to present doctored documents and to omit relevant information is decreased.
 - (b) Remote access to sensitive IT systems may not be allowed.
 - (c) It provides comfort and flexibility to the audit team as they would be working from their office/home environment.
 - (d) Time zone issues could also affect the efficiency of audits.

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.
- 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 be 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.

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 auditor 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.*
6. *What are the advantages and disadvantages of remote audit?*
7. *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 preparation of management information system (MIS) reports and electronic dashboards that give a high-level snapshot of business performance. In view of above you are required to briefly discuss the meaning of data analytics and example of such data analytics techniques.*

8. *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.*
9. *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.*
10. *Give example of emerging technologies available for Next Generation Audit along with the risks associated with it.*

Answers to Test Your Understanding Questions

1. The 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.
 - 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.
 - (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.

Answers to Integrated Case Scenario:

1. (c)
2. (a)
3. (d)
4. (a)
5. (a)

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 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. For details refer para 4.
4. For details refer para 5.1.
5. For details refer para 5.3.
6. For details refer para 5.5
7. For details refer para 6
8. For details refer para 7
9. For details refer para 8
10. For details refer para 9

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GROUP AUDITS

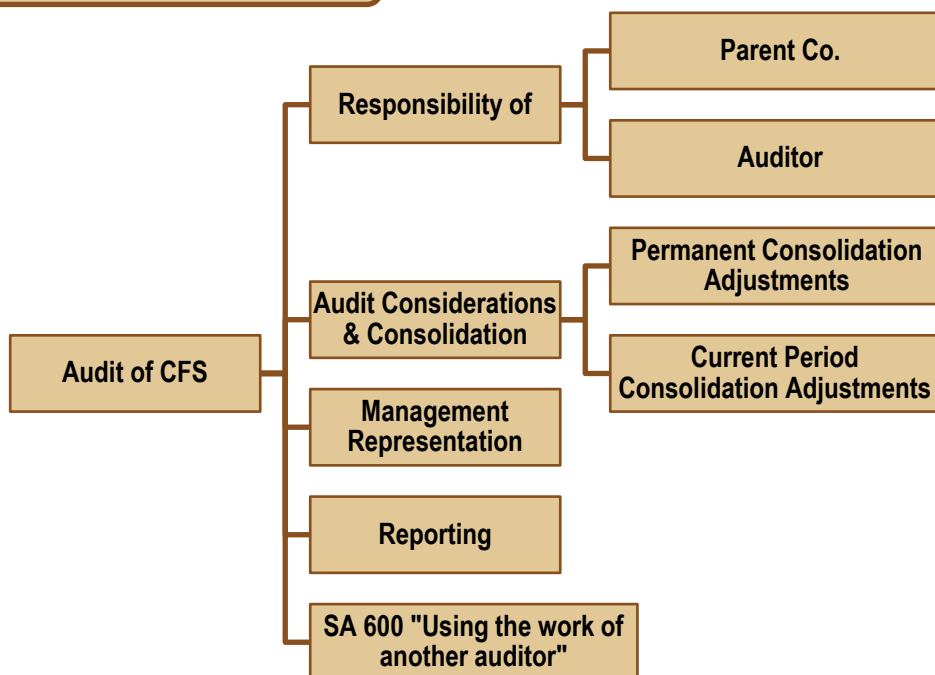


LEARNING OUTCOMES

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”

CHAPTER OVERVIEW



CA. Vikram is statutory auditor of a manufacturing company whose financial statements are required to be prepared in accordance with requirements of Ind AS. At the time of planning of audit of current year, it is noticed by him that said company, of which he is auditor, has purchased shares of another company located in USA. He further inquired from the management and found that all shares of US based company were purchased by Indian company.

Section 129 of Companies Act 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.

He had another recurring anxiety in his mind. Whether foreign subsidiaries are covered within scope of consolidated financial statements? Exhaustive reading of Ind AS 110 on "*Consolidated financial statements*" came to his help 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

groundwork for the preparation of consolidated financial statements in accordance with statutory provisions and applicable accounting standards.

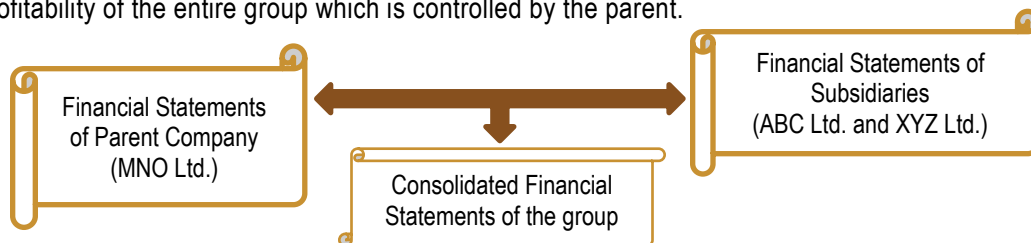
While consolidating financial statements, management was caught in a dilemma. The financial statements were going to be consolidated for the first time. However, the Indian parent company had acquired all shares in foreign subsidiary in the month of June. The question arose as to from which date consolidation is required. Is it required for the whole year or from the date of acquiring shares in foreign subsidiary? The management turned to Ind AS 110 for help. It became clear 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 consolidated financial statements were made ready by management 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, it came to the fore that accounts of foreign subsidiary were unaudited. CA Vikram was caught in a *Catch-22* situation. How should he proceed? What are the implications for unaudited accounts of a component included in group financial statements? What considerations would play in such a case?

1. INTRODUCTION

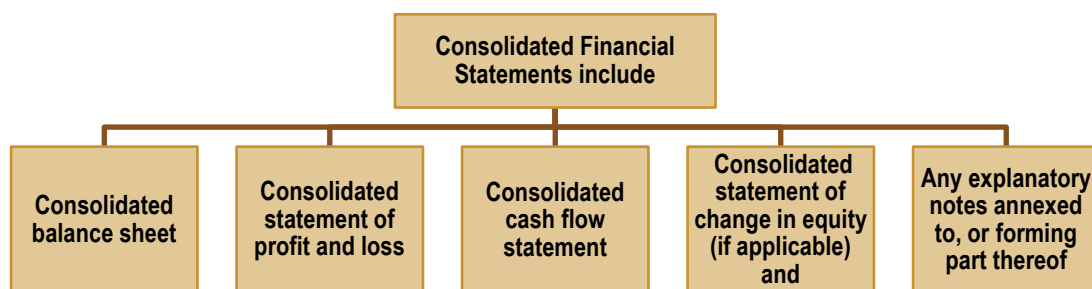
Consolidated Financial Statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. In other words, consolidated financial statements present the financial 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.



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 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 purpose, 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 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.

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 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 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.

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 31-3-2021. During the financial year 2021-22, 20% shares of Child Ltd were sold by Parent Ltd. Parent Ltd while preparing the financial statements for the year ended 31-3-2021 and 31-3-2022 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 31.03.2021 and sold 20% shares during the year ended 31.03.2022. Parent Ltd did not consolidate the financial statements of Child Ltd for the year ended 31.03.2021 and 31.03.2022.

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:

(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, and 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;
(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 Standards² under applicable financial reporting framework; and

¹ The auditor of the consolidated financial statements generally report 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 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.

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 of Interests in Joint Ventures OR Indian Accounting Standard (Ind AS) 110 – Consolidated Financial Statements, Indian

- (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

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.

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:

- | |
|--|
| <ul style="list-style-type: none">• 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. |
| <ul style="list-style-type: none">• 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. |
| <ul style="list-style-type: none">• 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. |
| <ul style="list-style-type: none">• 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

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 identifying the components. The auditor should verify that all the components have been included in the consolidated financial statements unless these components meet criterion for exclusion.

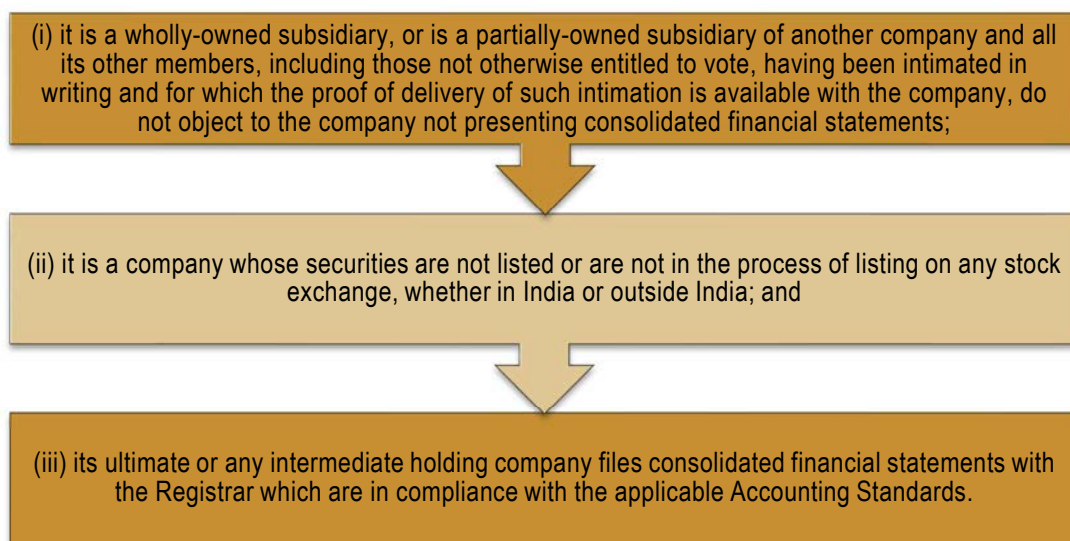
In respect of completeness of this information, the auditor should perform the following procedures:

(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 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 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:



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 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 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.

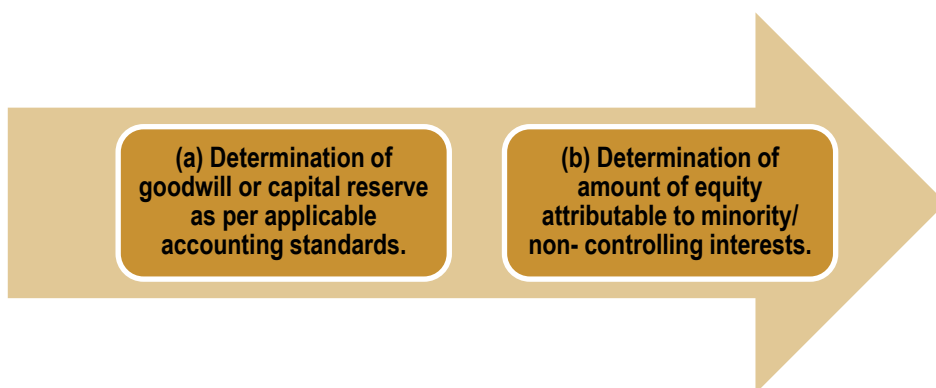
TEST YOUR UNDERSTANDING 1

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 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.

- ◆ 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.

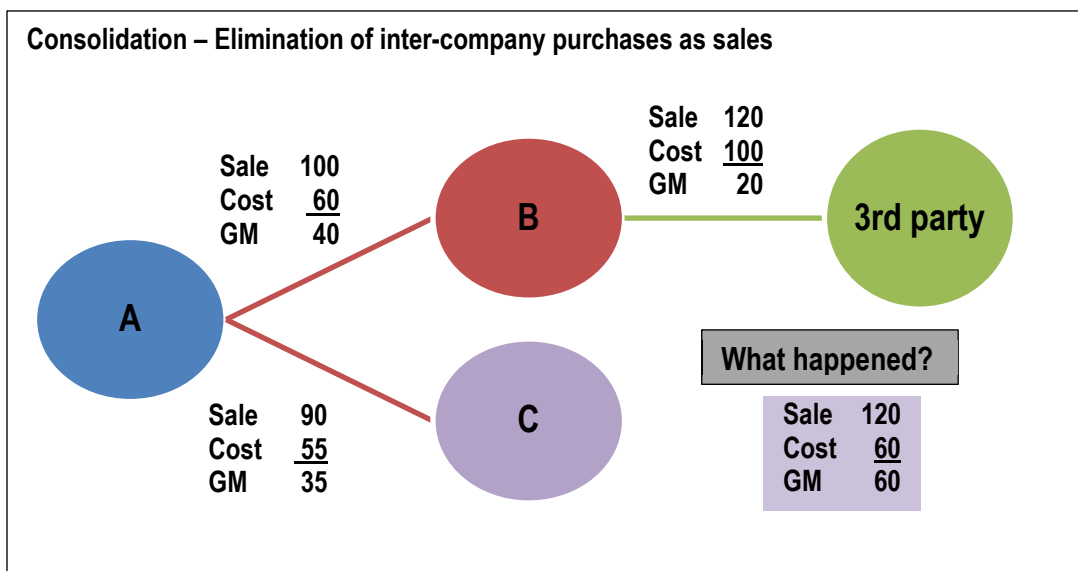
It may happen that while working out the permanent consolidation adjustments, in the case of one subsidiary, goodwill arises and in the case of another subsidiary, capital reserve arises. The parent may choose to net off these amounts to disclose a single amount in the consolidated balance sheet where 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.



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 2021-22, 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.



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

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.

(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 adjustment 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.

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

- (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.

Example 2. 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.

- (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.



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.

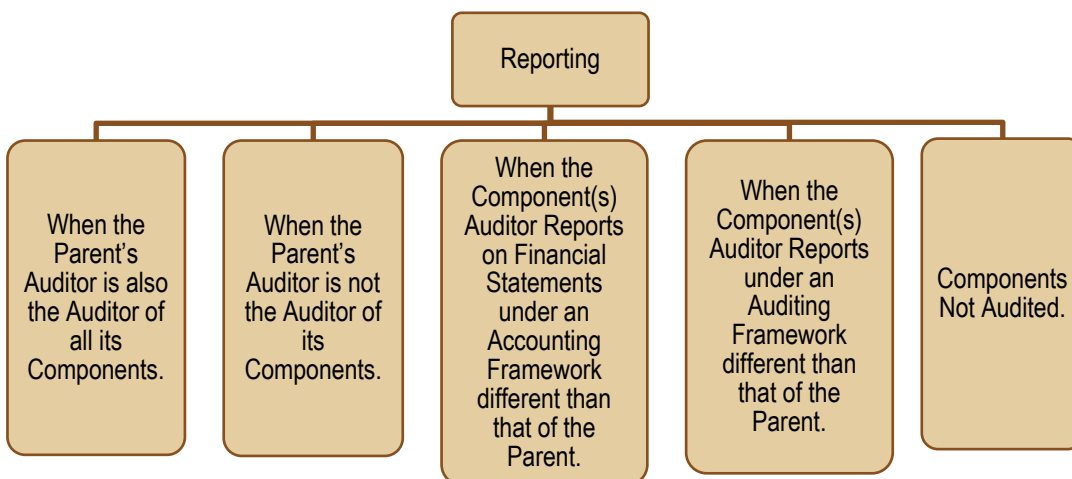
Examples of such representations include:

- (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.



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 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 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”.

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”.

TEST YOUR UNDERSTANDING 2

CA. Kajal is nearing completion of 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 such written representations can include?

TEST YOUR UNDERSTANDING 3

CA.M is auditor of consolidated financial statements of “D and D Limited” for year 2022-23. 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 2022-23: -

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 such information should be included in independent auditor’s report on consolidated financial statements of company? Also draft a suitable para by making necessary assumptions.

Integrated Case Scenario

While auditing consolidated financial statements of YK Industries Limited for the year 2022-23, a manufacturing company whose financial statements are required to be prepared in accordance with Division II of Schedule III of Companies Act, 2013, CA. Palash Shah notices as under: -

(A) The notes to accounts in respect of consolidated financial statements disclose additional information pertaining to the holding company and its subsidiaries. It provides disclosure regarding

percentages of consolidated net assets, of consolidated profit and loss and of total comprehensive income along with their respective amounts pertaining to holding company and its subsidiaries.

(B) It is noticed by him that financial statements of one foreign subsidiary included in consolidated financial statements are drawn up to 31st December, 2022 in accordance with legal requirements in US. He feels it to be weird and is of the view that consolidated financial statements of group could present a distorted picture. The management, in turn, informs him that it is not practicable to draw the financial statements of foreign subsidiary to 31st March, 2023.

(C) During the year 2022-23, goodwill of Rs.50 crore had arisen on account of the acquisition of a subsidiary during the year and there is no impairment loss as on the balance sheet date. Besides, adjustments have been made in consolidated financial statements with respect to intra-group indebtedness and those related to harmonizing different accounting policies being adopted by parent and its subsidiaries.

(D) It is noticed by him that one subsidiary was acquired on 15.6.22. He is in a dilemma as regards to the correctness of consolidation of its financial statements in group financial statements.

Besides, he is also in the process of finalising audit report including matters to be reported under CARO, 2020 in respect of consolidated financial statements. However, he is in a fix in respect of manner of reporting under CARO,2020 relating to consolidated financial statements.

Based upon above information and description, answer the following questions:-

1. Considering disclosure of additional information in consolidated financial statements as stated in para (A) of case study, which of the following statements is correct?
 - (a) The said disclosure is not proper as percentage of consolidated revenue from operations along with respective amount pertaining to holding company and its subsidiaries is also required.
 - (b) The said disclosure is not proper as percentage of other comprehensive income along with respective amount pertaining to holding company and its subsidiaries is also required.
 - (c) The said disclosure is not proper as percentages of consolidated revenue from operations as well as other comprehensive income along with their respective amounts pertaining to holding company and its subsidiaries are also required.
 - (d) The said disclosure is proper.

2. What should be auditor's proper course of action pursuant to situation highlighted in para [B] relating to financial statements of a foreign subsidiary?
- (a) The auditor should insist for drawing up of financial statements of foreign subsidiary to 31st March, 2023. The reason for impracticality is a mere excuse. In case of failure to redraw, he can modify his opinion in accordance with SA 705.
 - (b) The auditor can accept management's version.
 - (c) The auditor can accept management's version. However, it is his duty to verify adjustments made for effects of significant transactions or events occurring between 1st January 2023 and 31st March, 2023.
 - (d) The auditor should modify his opinion by quantifying the financial effects of such an inconsistency.
3. Which of the following statements is correct in respect of goodwill and other matters described in the case scenario?
- (a) Goodwill represents current period consolidation adjustments. Adjustments relating to intra-group indebtedness and those relating to harmonizing different accounting policies being adopted by the parent and its subsidiaries represent permanent consolidation adjustments.
 - (b) Adjustments relating to goodwill, intra-group indebtedness and those relating to harmonizing different accounting policies being adopted by parent and its subsidiaries represent current period consolidation adjustments.
 - (c) Goodwill represents permanent consolidation adjustments. Adjustments relating to intra-group indebtedness and those relating to harmonizing different accounting policies being adopted by the parent and its subsidiaries represent current-period consolidation adjustments.
 - (d) Goodwill and adjustments relating to harmonizing different accounting policies being adopted by the parent and its subsidiaries represent permanent consolidation adjustments. Adjustments relating to intra-group indebtedness represent current-period consolidation adjustments.
4. Which of the following statements is most appropriate regarding consolidation of financial statements of a subsidiary acquired on 15.6.22?

- (a) The auditor should verify that income and expenses of subsidiary are included in consolidated financial statements from the date it gains control of subsidiary and further such income and expenses are based on the amounts of the assets and liabilities recognized in consolidated financial statements at the acquisition date.
 - (b) The auditor should verify that income and expenses of subsidiary are included in consolidated financial statements for the complete financial year and further such income and expenses are based on the amounts of the assets and liabilities recognized in consolidated financial statements at the preceding reporting date.
 - (c) The auditor should verify that income and expenses of subsidiary are included in consolidated financial statements from the date it gains control of subsidiary and further such income and expenses are based on the amounts of the assets and liabilities recognized in consolidated financial statements at the preceding reporting date.
 - (d) The auditor should verify that income and expenses of subsidiary are included in consolidated financial statements for the complete financial year and further such income and expenses are based on the amounts of the assets and liabilities recognized in consolidated financial statements at the acquisition date.
5. As regards reporting under reporting CARO,2020 in respect of consolidated financial statements, which of the following is in accordance with requirements of law?
- (a) A separate report providing Clause by Clause reporting under CARO,2020 is required in respect of specified matters pertaining to parent and all subsidiaries incorporated in India.
 - (b) It would be sufficient if report under CARO,2020 in respect of standalone financial statements is supplemented with additional information in respect of all subsidiaries incorporated in India.
 - (c) A separate report under CARO, 2020 in respect of all subsidiaries incorporated in India together is required. It should be annexed with report under CARO,2020 in respect of standalone financial statements.
 - (d) Reporting of details of subsidiaries together with paragraph numbers of reports under CARO, 2020 of auditors of such companies incorporated in India containing qualifications or adverse remarks would serve the purpose.

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.
- 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 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?*
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 is not audited?*
8. *M Ltd. acquired 51 % shares of S Ltd. on 01-04-2019 and sold 25% of these shares during the financial year 2019-20. M Ltd. did not prepare Consolidated Financial Statements for the financial year 2019-20 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.*
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. *Venus Ltd. is a curtain manufacturing company having its corporate office in Punjab. The company is in the process of expansion and has acquired four companies during the year. Pradyuman & Co. is the principal auditor of the company while the audit of all the companies acquired during the year is being conducted by Jha & Jha Associates. During the course of audit, CA Pradyuman, the engagement partner asked the management of Venus Ltd. at the corporate office that in order to conduct the audit of the consolidated financial statements, his audit firm is required to conduct audit of the financial statements of all the components also (Companies acquired during the year). To this, the management asked CA Pradyuman to consider the audit reports of the component auditor already provided to his audit team and to communicate with the component auditor for any discussion they wish to have. CA Pradyuman contended that for the purpose of audit of consolidated financial statements either*

his firm is required to conduct an audit of all the component's financial statements or he needs the working papers of the component auditors. Is the contention of CA Pradyuman correct?

12. *Kukreja & Associates is the principal auditor of MN Ltd. The company is engaged in the manufacture of sports items and operates through its 14 branches all over India. With respect to the audit of branches, the company has appointed seven Chartered Accountant firms, each firm conducting the audit of two branches. The audit reports in respect of accounts of branches have already been sent to the principal auditor. While analysing the work of the branch auditors, CA Kukreja, the engagement partner, asked the branch auditors to share with him a summary of the audit procedures and findings in respect of the accounts of the branches examined by them. CA Kukreja also asked one of the branch auditor to share his working paper with respect to the two branches examined by that branch auditor for his review and return. Is the principal auditor correct in asking the branch auditors for sharing the summary and the working papers for his review.*

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
 - (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 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.

Answer to Integrated Case Scenario

1. (b)
2. (c)
3. (c)
4. (a)
5. (d)

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 6.118
- 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 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.

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 01.04.2019 and sold 25% shares during the year ended 2019-20. M Ltd did not consolidate the financial statements of S Ltd for the year ended 31.03.2020 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 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 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 SI 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 & Associates, 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
 - (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.** As per SA 600, "Using the work of Another auditor", the principal auditor is normally entitled to rely upon the work of component 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. The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor.

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 that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

Accordingly, CA Pradyuman, can perform the above mentioned audit procedures. However, the audit of the component's financial statements by the principal auditor is not required.

So, the contention of CA Pradyuman that for the purpose of audit of consolidated financial statements he is required to conduct an audit of the components financial statements is not correct.

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

Accordingly, it is the discretion of the component auditor as the working papers with respect to the components examined by the component auditor are the property of the component auditor.

So, the contention of CA Pradyuman is not correct.

- 12.** In terms of SA 600 "Using the Work of Another auditor", 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. 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.

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.

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.

Accordingly, CA Kukreja is correct in asking the branch auditors to share with him the summary of their audit procedures and findings in respect of the accounts of the branches examined by them.

Further, CA Kukreja has asked one of the branch auditors to share with him the working papers with respect to the branches examined by such branch auditor for the former's review and return.

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

Accordingly, it is the discretion of the branch auditor as the working papers with respect to the branches examined by the branch auditor are the property of the branch auditor.

So, CA Kukreja is not correct in asking the branch auditor to share with him the working papers with respect to the branches examined by the branch auditor.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES



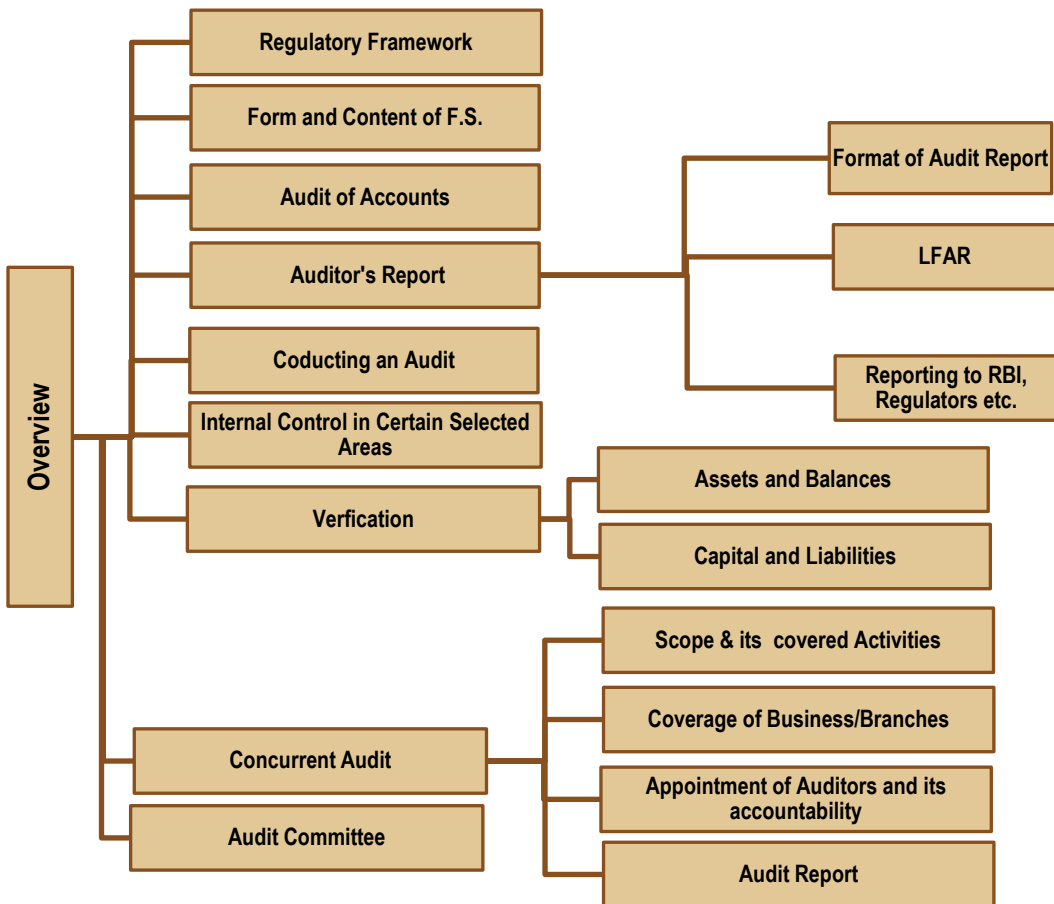
UNIT 1 – SPECIAL FEATURES OF AUDIT OF BANKS

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 feature 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.

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 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 in bank's working.

Why are treasury operations of a bank significant from point of view of an auditor? Treasury operations are responsible for processing of all financial market transactions and play a crucial role in managing risks. Investments and forex & derivatives form two main components of 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 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 considering to go through complaints lodged by bank customers. What is necessity to plan procedures in this respect? Does auditor of a bank have anything to do with customer complaints? Certainly. It is due to the reason 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 credit recovery policy of the Bank and guidelines of RBI regarding accounting and income recognition in this respect. He is also considering 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 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 such a review is 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 frauds 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.



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.

Example

-  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).
-  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.

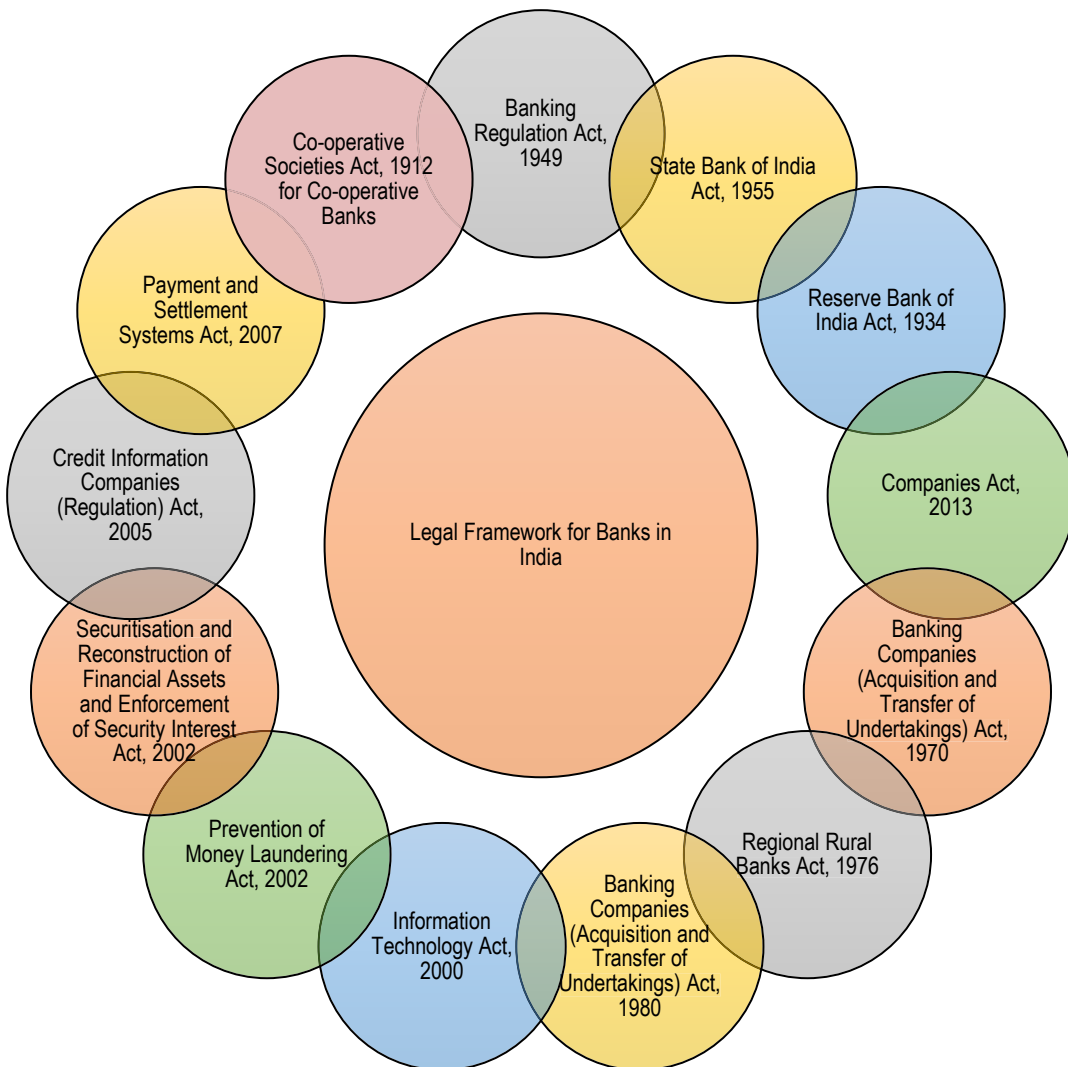
The auditor should consider the effect of the above factors in designing his audit approach. It is imperative for Branch Auditors and SCAs (Statutory Central Auditors) to have detailed knowledge of the products offered and risks associated with them, and appropriately address them in their audit plan 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.



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

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.
- 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.

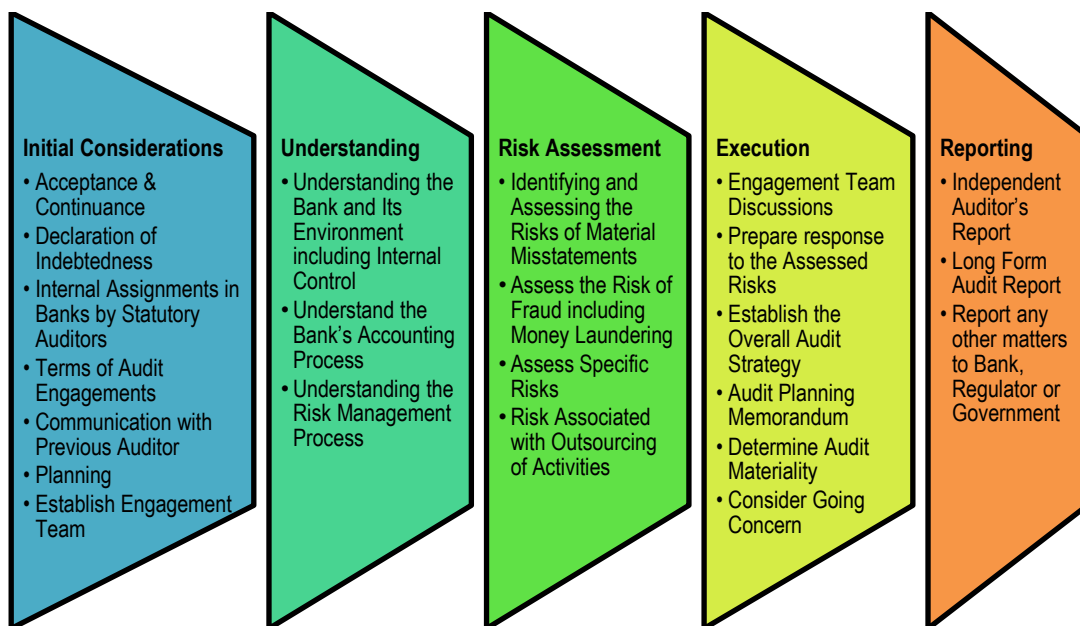
Authority appointing the Auditors - As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the concerned bank acting through its Board of Directors.

In either case, approval of the Reserve Bank is required before the appointment is made.



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/f/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 12 of CA Intermediate Auditing and Assurance 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.

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:

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.

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.

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 8. **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

- 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/alterd except by the authorised personnel.

- 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



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, maintain 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 interval 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

	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 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, 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 to check whether 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, 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 title of the bank. • 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 advices (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. • 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.

Example 2

While doing the audit of a branch of XYZ bank for the year ended 31st March 23, 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.

(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:- - Paid up capital, reserve, any credit balance in profit & loss account of bank, amount of loan taken from RBI and amount of refinance taken from EXIM bank, NHB, SIDBI and NABARD - Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery. - Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.

	○ 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 payment made by other branches but not adjusted by the link branches. ○ 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:- ○ Net credit balance in branch adjustment accounts. ○ Borrowings from abroad by banks in India needs to be considered as 'liabilities to other' and thus, needs to 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. • Examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches. • It may be noted that, even though interest accrues daily, it is recorded in the books only at periodic intervals. Thus, examine whether such interest accrued but not accounted for in books is included in the computation of DTL. • 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 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 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. • 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 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 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 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 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/on line 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 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 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 the 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 the 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 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:

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 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

Example 3

FT Cooperative Bank lent 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 (for provisioning norms refer Chapter 12 of Intermediate Auditing & Assurance 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.
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 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 repetitive basis. In such cases, auditor can consider the classification of account based on other parameters and functioning of the account.
<i>Asset classification to be borrower wise and not facility wise</i>	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.
Government Guaranteed Advances	- If government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized. However, for 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 of interest/sanction of additional credit facilities etc. to help in curing of 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. - 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. 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 scantily with important details left out. In these cases, it is also noticed that cash credit limits to 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 above information prompt auditor to suggest change in asset classification of above accounts? What does 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 purchase, 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. • 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 record 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. • 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 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 4. 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 respect 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.
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 is collected by the branch and the original copy is sent to the Head Office along with the transfer of such Tax Deducted at Source (TDS) amount to Head Office on periodic basis as defined. - 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 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 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.

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.
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	- Review the ageing statements pertaining to these items. - Examine the recoverability of old outstanding items.

Government Account	• 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 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 framework and definition of bank capital was framed by the Committee on Banking Regulations and Supervisory Practices of the G-10 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 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 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 6: For secured housing loans upto ₹ 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.

II. RESERVES AND SURPLUS

The following are required to be disclosed in the balance sheet under the head 'Reserves and Surplus'.

Statutory Reserves*

Capital Reserves*

Share Premium*

**Revenue and Other Reserves
including investment
Fluctuation Reserve***

**Balance in Profit and Loss
Account**

*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

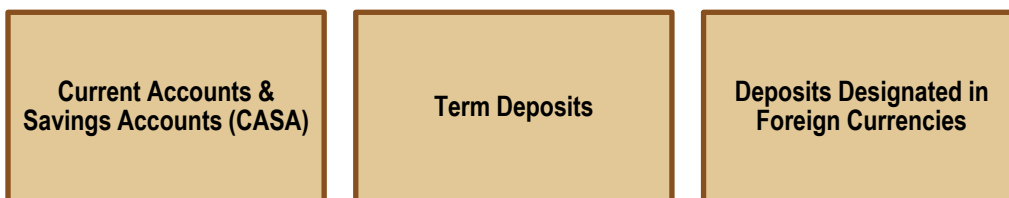
The auditor should verify the opening balances of various reserves with reference to the audited balance sheet of the previous year. Additions to or deductions from reserves should also be verified in the usual manner, e.g., with reference to board resolution. In the case of statutory reserves and share 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, need 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:



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 be appearing in 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	• <i>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.</i> • 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 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.
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 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 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'.

Bills payable	Inter-office adjustments (net)	Interest accrued	Others (including provisions)

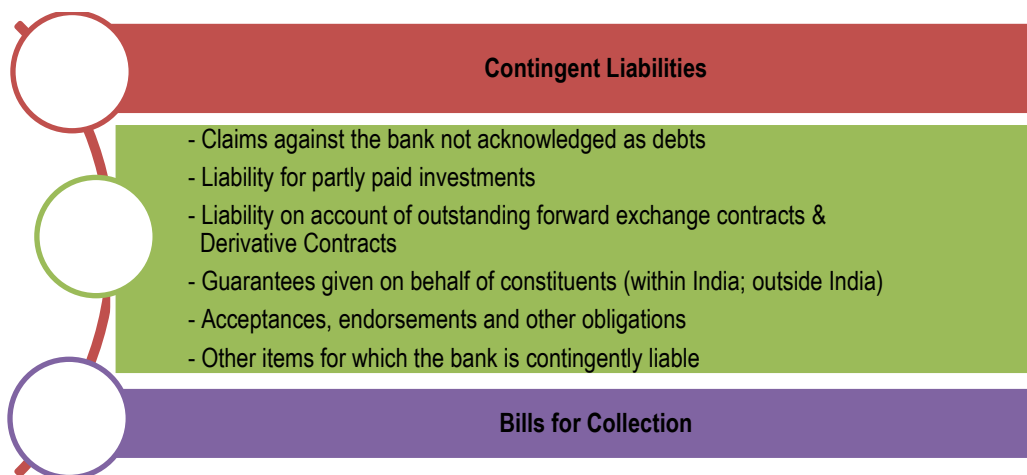
Audit Procedures:

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. - 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 advices 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.

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 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 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 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 &	• 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

derivative contracts	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. - 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 in 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,
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 4:

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 securities were being 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:

- 
- Whether, in the auditor's opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank.
 - In case the auditor had called for any explanation or information, whether it has been given and whether it is satisfactory.
 - Whether or not the transactions of the bank, which have come to the auditor's notice, have been within the powers of that bank.
 - Whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of audit.
 - Whether the profit and loss account shows a true balance of profit or loss for the period covered by such account.
 - Any other matter which the auditor considers should be brought to the notice of the Central Government.

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.

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
- (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 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.

Auditor should also consider the compliance with provisions of Standards on Auditing.



8. 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 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.
- ✓ 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

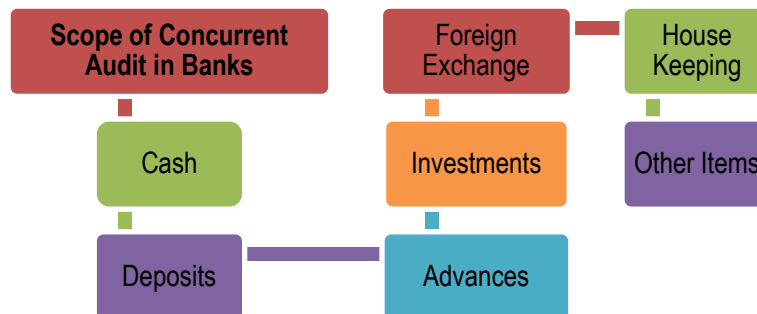
system of someone, other than the person involved in the operations, verifying the authenticity of the transaction/activity on a regular basis, so that any deviation from the laid down procedures can be noticed in the shortest possible time and remedial action can be taken.

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.

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.

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.
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. • 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, DDDR 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).
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

• <i>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.</i>
• <i>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.</i>
• <i>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.</i>
• <i>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.</i>

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.
• 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 view point 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 concurrent audit of 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 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.

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 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 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. 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 was holding this stock for last 15 months.

How do you view the above situation? Discuss.

Integrated Case Scenario

CA. Madhusudan is conducting concurrent audit of a branch of a nationalized bank. It is a large branch having deposits of ₹ 350 crore and advances of ₹ 600 crore respectively. The deposits of branch consist of term deposits apart from CASA deposits. It is an old branch in operation since late 70s. Therefore, there are many dormant deposit savings, current and term deposit accounts at the branch.

Of late, the top management of the bank has been pushing for aggressive targets in opening of CASA deposits. He wants to ensure that CASA deposit accounts opened by the branch during his term comply with KYC norms.

During the course of concurrent audit of a particular month, he finds that temporary over limits are granted to few borrowers availing cash credit facilities up to 10% of their respective sanctioned limits. Granting of such over limits falls within the powers of Chief Manager of the said branch. It is also noticed by him that temporary overdrafts are allowed to few customers in their current accounts. However, granting of these temporary overdrafts also falls in Chief Manager's delegated powers. Temporary over limits and overdrafts as discussed above have been adjusted and paid before the end of the month.

It is further noticed by him during the same month that branch has sanctioned 5 fresh advances falling within Chief Manager's powers and conforming to bank norms aggregating to ₹ 10 crore. All

these sanctioned advances pertain to same industry i.e., jute mills manufacturing jute sacks. He feels that branch's approach is not proper and sanction of 5 advances to the same industry lacks diversity and lending decision of branch is not proper.

He further notices that during the month, one borrower of branch falling under definition of "small enterprise" in MSME sector has shifted its credit facilities from the branch to a bank in private sector. The branch has levied foreclosure charges on outstanding credit facilities pertaining to borrower by disregarding "*Code of Bank's Commitment to Micro and Small Enterprises*". The borrower is still having current account with branch. Reversal of such charges would lead to revenue loss for branch. He is in a fix as far as reporting is concerned.

Keeping in view above, answer the following questions: -

1. As regards dormant deposit accounts in the branch, which of the following is not part of duty of concurrent auditor?
 - (a). Verifying that dormant accounts are revived with appropriate authority
 - (b). Examining authorisation for withdrawals
 - (c). Following up with account holders to ensure status of accounts remains active
 - (d). Verifying that dormant accounts at the branches ageing more than 10 years have been transferred to Deposit Education and Awareness Fund (DEAF)
2. The concurrent auditor wants to ensure that fresh CASA accounts opened in the branch are KYC compliant. Which of the following best sums up scope of KYC guidelines prescribed by RBI?
 - (a). The basic purpose of such guidelines is to weed out duplicate customers at the same branch.
 - (b). Such guidelines contain detailed requirements for banks to enable them to draw a 360-degree credit profile of the customers by monitoring of transactions. Its primary purpose is assisting banks in making prudent credit decisions.
 - (c). Such guidelines have a basic objective of ensuring credit of Direct benefit transfers (DBT) in accounts of deserving account holders.
 - (d). Such guidelines contain detailed requirements in respect of customer acceptance policy, customer identification procedures, monitoring of transactions and risk management.

3. Which of the following statements is most appropriate as regards reporting of matters relating to temporary over limits in cash credit accounts and temporary overdrafts in current accounts?
 - (a). The said instances cannot be reported as these fall in powers of Chief Manager.
 - (b). The said instances can be reported in monthly concurrent audit report. No discussion is necessary with Chief Manager in this respect to ensure sanctity of report.
 - (c). The said instances can be reported in monthly concurrent audit report. However, a discussion is necessary with Chief Manager in this respect.
 - (d). The said instances cannot be reported as these fall in powers of Chief Manager and have been adjusted and paid before the end of the month.
4. Which of the following statements is most appropriate regarding sanction of fresh advances to borrowers in the same industry in a month from concurrent auditor's perspective?
 - (a). Such a lending lacks diversity and needs to be reported without fail.
 - (b). Such a lending increases credit risk for branch and needs immediate attention of higher authorities of bank.
 - (c). Lending has been made within Chief Manager's powers. It does not fall in concurrent auditor's domain to question wisdom of lending decision conforming to bank norms.
 - (d). Although lending has been made within Chief Manager's powers, branch should have reported to higher authorities flagging sanction of fresh advances to same industry. Only this aspect should be reported in concurrent auditor's report.
5. As regards matter of levying of foreclosure charges described in case scenario, what is appropriate course of action for concurrent auditor?
 - (a). The matter should be reported even though it would lead to revenue loss for branch.
 - (b). The matter should not be reported as it is part of duties of concurrent auditor to safeguard branch's revenue interests.
 - (c). The matter should be reported only for its disregard of Code without highlighting revenue impact.
 - (d). The matter concerns branch management's decision. It does not fall in purview of concurrent audit.

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 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.
- 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 the major part of the assets of the bank. The audit of advances requires the 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.
- 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 house-keeping etc.
- 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 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, 23 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 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 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 2022-23. You are part of the audit team for 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 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 2022. While doing the statutory branch audit for the year ended 31st March 2023, 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 document 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 31/3/2023. However, the audited financials are received on 10th April 2023 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 31/3/2023. 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.*

Answers to Test your understanding

1. An account becomes NPA when it ceases to generate income for bank. In the given situation, all the examined five accounts are operating satisfactorily. There is no reason for suggesting changes in their classification.

The matter of scantily filling up loan applications and lack of 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 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 of 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 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 verify physical quantities only.

In 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. 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.

Answers to Integrated Case Scenario

1. (c)
2. (d)
3. (c)
4. (c)
5. (a)

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 to be taken to income unless interest is realized. However, for 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 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.

(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 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. 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.

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.

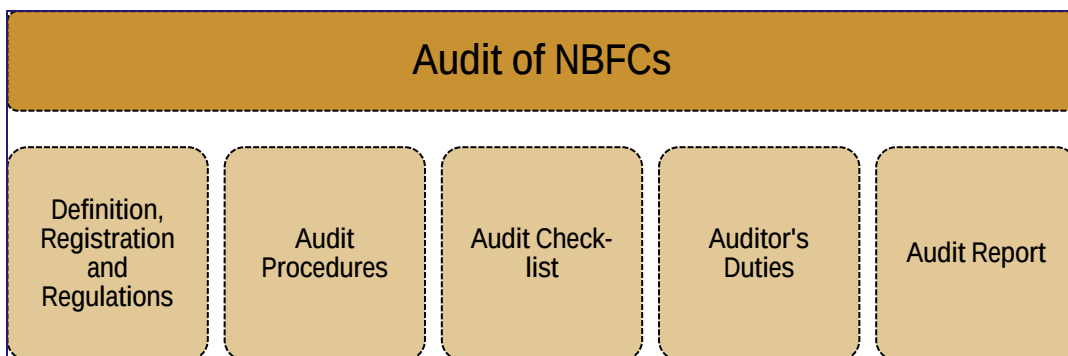
UNIT 2 – SPECIAL FEATURES OF AUDIT OF NON-BANKING FINANCIAL COMPANIES (NBFCs)

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.

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 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 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 NBFC having applicability of Ind-AS are required to be prepared in accordance with Division III of Schedule III of 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.

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

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;"

Non-Banking financial Institutions.

Non-banking Financial Institutions carry out financing activities but their resources are not directly obtained from the savers as debt. Instead, these Institutions mobilize the public savings for rendering other financial services including investment. All such Institutions are financial intermediaries and when they lend, they are known as Non-Banking Financial Intermediaries (NBFIs) or Investment Institutions. Eg:

- ◆ UNIT TRUST OF INDIA
- ◆ LIFE INSURANCE CORPORATION (LIC)
- ◆ GENERAL INSURANCE CORPORATION (GIC)



The image displays three logos stacked vertically. The top logo is for UTI Mutual Fund, featuring a stylized orange and blue emblem with the text 'uti' in white and 'UTI Mutual Fund' below it. The middle logo is for LIC (Life Insurance Corporation), showing two hands holding a flame with the motto 'आपत्काले वहायामहे' in Devanagari script. The bottom logo is for GIC Re (General Insurance Corporation), featuring a blue stylized 'G' with a white square inside, and the motto 'आपत्काले दक्षिष्यामि' in Devanagari script above the text 'GIC Re'.

*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

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 a 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.

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.

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 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.

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.

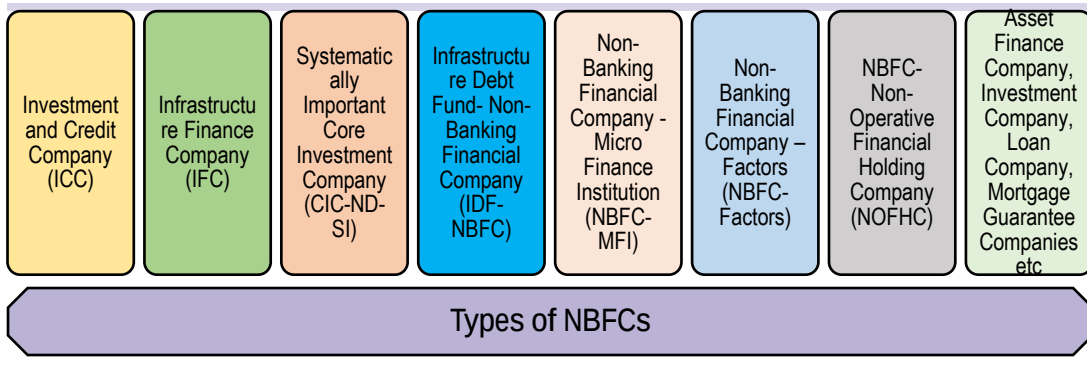
A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

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 systemically important and non-systemically important (NBFC-NDSI and NBFC-ND); 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).

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 i.e. a non-banking financial company being a Core Investment Company referred to in the Core Investment Companies (Reserve Bank) Directions, 2016, which is not a Systemically Important Core Investment Company, as defined in sub-paragraph (xxv) of paragraph 3 of the Core Investment Companies (Reserve Bank) Directions, 2016.
➤ 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.

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

- (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 INR 500 Crore and below INR 1000 Crore (except those necessarily featuring in Middle Layer) will be known as NBFC- BL (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:

- 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. 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- Non-Banking Financial Company – Systemically Important Non-Deposit Taking Company & Deposit Taking Company (Reserve Bank) Directions, 2016* shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than 15 % of its aggregate risk weighted assets on-balance sheet and of risk adjusted value of off-balance sheet items.

The Tier I capital in respect of applicable NBFCs (other than NBFC-MFI and IDF-NBFC), at any point of time, shall not be less than 10% by March 31, 2017.

Applicable NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 percent or more of their financial assets) shall maintain a minimum Tier I capital of 12 %.

However, in the case of Non-Systemically Important Non-Deposit Taking Company (Reserve Bank) Directions, 2016, Net Owned Fund requirements have to be complied.

The RBI vide it's Guidelines dated 22nd October, 2021 has revised the regulatory framework for NBFC basis the Scale. There are many changes made depending on the categorization of the NBFCs and those are broadly in the areas of NPA classification, Capital requirements, Prudential Guidelines specifically for NBFC- ML and NBFC-UL relating to Concentration of credit/ Investment, Sensitive Sector Exposure, Loans to Related parties and KMP, for NBFC-UL address Large Exposure framework, Internal exposure limit, Stricture and more broader Governance Guidelines, etc.

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] (b) Bonds of public sector banks (c) Fixed deposits/certificates of deposits/bonds of public financial institutions (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	0 20 100 100 50
(iii)	Current assets: (a) Stock on hire (net book value) (b) Intercompany loans/deposits (c) Loans and advances fully secured against deposits held (d) Loans to staff (e) Other secured loans and advances considered good [Except at (vi) below] (f) Bills purchased/discounted (g) Others (To be specified)	100 100 0 0 100 100 100
(iv)	Fixed Assets (net of depreciation): (a) Assets leased out (net book value) (b) Premises (c) Furniture & Fixture	100 100 100
(v)	Other assets: (a) Income tax deducted at source (net of provision) (b) Advance tax paid (net of provision) (c) Interest due on Government securities (d) Others (to be specified)	0 0 0 100

(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
(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;

(ii) “Sub-Standard Asset” shall mean:

- (a) an asset which has been classified as non-performing asset for a period not exceeding 18 months (in case of NBFCs covered in Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016);

The period ‘not exceeding 18 months’ stipulated in this sub-clause shall be ‘not exceeding 12 months’ for the financial year ended March 31, 2018 and thereafter for NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

- (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 25 of these Directions.

(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’ (in case of NBFCs covered in Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016).

The period ‘exceeding 18 months’ stipulated in this sub-clause shall be ‘exceeding 12 months’ for the financial year ended March 31, 2018 and thereafter for NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

- (iv) Loss Asset shall mean:
 - (a) an asset which has been identified as loss asset by the applicable NBFC or its internal or external auditor or by the Bank during the inspection of the applicable NBFC, to the extent it is not written off by the applicable NBFC; and
 - (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 six months or more;
 - (b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;
 - (c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;
 - (d) a bill which remains overdue for a period of six months or more;
 - (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 six months or more;
 - (f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;

NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, period of ‘six months or more’ stipulated in sub-clauses (a) to (f) shall be ‘three months or more’, for the financial year ended March 31, 2018 and thereafter].

This implies for NBFCs covered in Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, the criteria is 6 months only.

- (g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;

[NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, the period of 'twelve months or more' stipulated in this sub-clause shall be 'three months or more' for the financial year ended March 31, 2018 and thereafter].

It implies that as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, the criteria is 12 months only.

- (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].

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:

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: Every NBFC (covered under Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016) shall make provisions for standard assets at 0.40 per cent by the end of March 2018 and thereafter, of the outstanding, which shall not be reckoned for arriving at net NPAs.

Note: As per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, every applicable NBFC shall make provision for standard assets at 0.25 percent of the outstanding amount.

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 NBFC - Non-Systemically Important Non-deposit Taking Company (Updated as on February 17, 2020) and Master Direction NBFC - Systemically Important Non-deposit Taking Company and Deposit Taking Company (Updated as on February 17, 2020) 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 a 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 it to undertake a host of business activities, but companies generally tend 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 a 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 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 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 a 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 from 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 a 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 a NBFC holding public deposits have been lodged in safe custody with a designated scheduled 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 a 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 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 into in accordance with scale-based regulations? Suggest 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 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 a 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.
- 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 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/rediscouted 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 a 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. 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 be 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 No. DNBS.PPD.03/66.15.001/2016-17 dated September 29, 2016

- (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 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 - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company 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 31 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 one month from the date of finalization of the balance sheet and in any case not later than December 30th of that year.

The format of Statutory Auditor's Certificate (SAC) to be submitted by NBFCs has been issued vide DNBS. PPD.02/66.15.001/2016-17 Master Direction- Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016.

(B) In the case of a 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
 - (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 Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 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;
- (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 - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016;
- (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 NBS 1 to – Non- Banking Financial Company Returns (Reserve Bank) Directions, 2016;
- (xi) Whether the company has furnished to the RBI within the stipulated period the quarterly return on prudential norms as specified in the Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;
- (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 Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016;
- (iv) In respect of Systemically Important Non-deposit taking NBFCs as defined in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016:
 - (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 Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

(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) Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.
- 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;
 - (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

As per Rule 4 (1)(iv) of the Companies (Indian Accounting Standards) Rules, 2015 and as amended by Companies (Indian Accounting Standards) (Amendment) Rules, 2016, NBFCs are required to comply with Indian Accounting Standards (Ind AS) as under-

- (i) Accounting periods beginning 1 April 2018: Listed and unlisted NBFCs having a net worth of ₹ 500 crore or more and holding, subsidiary, joint venture or associate companies of such NBFCs;
- (ii) Accounting periods beginning 1 April 2019: All other listed NBFCs, unlisted NBFCs having a net worth of ₹ 250 crore or more but less than ₹ 500 crore and holding, subsidiary, joint venture or associate companies of such NBFCs.

The net worth shall be calculated in accordance with the standalone financial statements of the NBFCs as on 31st March 2016 or the first audited financial statements for accounting period which ends after that date.

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:

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			

Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of previous reporting period (₹)
(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			
LIABILITIES AND EQUITY			
LIABILITIES			
(1) Financial Liabilities (a) Derivative financial instruments (b) Payables (i) Trade Payables			

Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of previous reporting period (₹)
(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 (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 value 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)			
Expenses			
(a) Finance costs			
(b) Fees and commission expense			
(c) Net loss on fair value 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			

Particulars	Notes No.	Figures for the current reporting period (₹)	Figures for the previous reporting period (₹)
(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)			
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)			

Particulars	Notes No.	Figures for the current reporting period (₹)	Figures for the previous reporting period (₹)
(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 (₹)			
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:

- 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.

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 prepared in accordance with requirements of Ind AS. The following is extract of statement of profit and loss for year ending 31st March, 2023 in accordance with Division III of Schedule III of Companies Act, 2013. Previous year figures are ignored.

Particulars	Note No.	Figures for year ended 31 st March, 2023 (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 Companies Act, 2013?

Integrated Case Scenario

CA. Parampara is statutory auditor of “*Lohit Finance Limited*”, a micro finance institution, working pre-dominantly in states popularly described as “seven sisters of North East”, West Bengal, Odisha and Andhra Pradesh. It is a non-deposit taking NBFC catering to credit requirements of rural and semi-urban households and provides small ticket loans. She has performed audit procedures for year 2022-23 and following further information is given as under:-

(A) The Board of Directors of the company has passed a resolution in its meeting held on 1.5.22 for non-acceptance of public deposits during year ended 31st March, 2023.

(B) The company has obtained certificate of registration dated 15th March, 2012 from RBI in pursuance of section 45-IA of RBI Act, 1934 and it is entitled to hold such certificate of registration in terms of its financial assets/income pattern for year ended 31st March, 2023.

(C) The company has identified instances of cash embezzlement by the employees during the year. Such instances relate to employees fleeing after collection of instalments from customers at some centres. The total amount involved is ₹15 lacs and ₹ 5 lacs have been recovered subsequently. The matter has also been reported in note 35 of financial statements.

(D) It falls in middle layer of scale-based regulations and regulations for a systemically important non-deposit taking NBFC are applicable to it. Its capital adequacy ratio is stated in note 36 of financial statements.

(E) Audit procedures performed by her included testing design and operating effectiveness of controls relating to allowances for loan losses using Expected credit loss model (ECL) in accordance with Ind AS 109. Tests of details performed by her included verifying assumptions affecting ECL calculations.

Keeping in view above information, answer the following questions: -

1 The Board of Directors has passed a resolution for non- acceptance of public deposits during year 2022-23. Which of the following statements is most appropriate in this regard as regards reporting obligations of auditor are concerned?

(a) Passing of board resolution for non-acceptance of public deposits, being an internal

- governance matter, is not required to be reported by auditor.
- (b) Matter of passing of board resolution for non-acceptance of public deposits is a specific reporting requirement for auditor under CARO, 2020.
 - (c) Matter of passing of board resolution for non-acceptance of public deposits is a specific reporting requirement in auditor's additional report to the Board of Directors of the company.
 - (d) Matter of passing of board resolution for non-acceptance of public deposits is a specific reporting requirement in auditor's additional report to the Board of Directors of the company as well as under CARO, 2020.
2. Which of the following statements is most appropriate in respect of reporting requirements relating to certificate of registration of the company obtained from RBI as described in para [B] of the case?
- (a) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 in auditor's additional report to the Board of Directors of the company.
 - (b) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 in auditor's additional report to the Board of Directors of the company as well as under CARO, 2020.
 - (c) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 under CARO, 2020.
 - (d) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 in auditor's additional report to the Board of Directors of the company as well as under CARO, 2020. Further, it is also required to be reported in auditor's additional report to Board of Directors whether company is entitled to hold such certificate in terms of its financial assets/income pattern.
3. Regarding instances of cash embezzlement identified by the company during the year, which of the following statements best fits into reporting requirements of an auditor?
- (a) Such instances are required to be reported under CARO, 2020 under relevant clause.
 - (b) Cash embezzled amount is less than ₹1 crore. No reporting under CARO, 2020 is required of such instances.
 - (c) Such instances are required to be reported under CARO, 2020 as well as in auditor's additional report to Board of Directors of company.

- (d) Such instances are to be specifically reported in auditor's report under Section 143(3) of Companies Act, 2013.
4. As regards description of capital adequacy ratio as described in para [D] of case, which of the following statements meets regulatory reporting requirements?
- (a) Auditor has to ascertain and verify whether such ratio has been disclosed in financial statements in notes to accounts.
 - (b) Auditor has to ascertain and verify whether such ratio as disclosed in NBS-7 has been correctly arrived at.
 - (c) Auditor has to ascertain and verify whether such ratio as disclosed in NBS-7 has been correctly arrived at and whether such ratio is in compliance with minimum CRAR prescribed by RBI.
 - (d) Auditor has to ascertain and verify whether such ratio has been disclosed in financial statements in notes to accounts and has been correctly arrived at and is in compliance with minimum CRAR prescribed by RBI.
5. The auditor has performed audit procedures relating to allowances for loan losses using ECL in accordance with Ind AS 109. As these allowances involve significant judgment and estimates, she wants to state how it was addressed by her. How she can do that?
- (a) By stating it in Auditor's additional report to Board of Directors.
 - (b) By stating it in matters as required under Section 143(3) of Companies Act.
 - (c) By incorporating Emphasis of Matter Paragraph in Independent auditor's report.
 - (d) By identifying it as Key audit matter in Independent auditor's report.

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.
- 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.

- Besides issuing a report in accordance with requirements of section 143(3) of Companies Act 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 companies in this regard. Under these directions, 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.
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 audit of NBFC - Investment and Credit Company (NBFC-ICC).
5. You are appointed as the auditor of a 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 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 primarily into the business of selling computer parts. However, the company 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., a 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 differences in the presentation requirements between Division II and Division III of Schedule III of the Companies Act, 2013. Help 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 was having 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 2023. The company appointed Mr. Kabra as its statutory auditors for the year 2022-23. Advise the auditor with reference to auditor procedures to be taken and reporting requirements on the same in view of CARO 2020?*

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 company undertakes only permissible activities applicable to such type of NBFCs like providing online marketplace to participants for lending and borrowing. It should not be engaged in 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 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 Companies Act, 2013.

Answers to Integrated Case Scenario

1. (c)
2. (d)
3. (a)
4. (c)
5. (d)

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.

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 a Non-Deposit Taking Non-Systemically Important 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 - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Apart from the aspects enumerated 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 Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016;

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) Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

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 restrict 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.

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 2021). The auditor is required to report on the same as per Clause (xvi) of Paragraph 3 of CARO 2020.