

# **PART-III**

## GUIDANCE NOTE ON AUDIT OF PROPERTY, PLANT AND EQUIPMENT

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*The following is the text of the Guidance Note on Audit of Property, Plant and Equipment (PPE) issued by the Auditing and Assurance Standards Board (AASB) of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" issued by the Institute.*

1. Paragraph 26 of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" states that "Guidance Notes are issued to assist professional accountants in implementing the Engagement Standards and the Standards on Quality Control issued by the AASB under the authority of the Council. Guidance Notes are also issued to provide guidance on other generic or industry specific audit issues, not necessarily arising out of a Standard. Professional accountants should be aware of and consider Guidance Notes applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Guidance Note should be prepared to justify the appropriateness and completeness of the alternate procedures adopted by him to deal with the objectives and basic principles set out in the Guidance Note."
2. This Guidance Note, does not supersede the Institute's publications which provide guidance on audit of Property, Plant and Equipment (PPE) with special reference to certain statutory requirements, e.g., the guidance contained in the Statement on the Companies (Auditor's Report) Order, 2003.
3. The Guidance Note has been prepared considering the relevant Revised Accounting Standard 16, "Property, Plant & Equipment" (corresponding to IAS 16) which is being issued by the Institute pursuant to the decision to converge with the International Financial Reporting Standards (IFRS) in respect of accounting periods commencing on or after April 1, 2011 and the existing Accounting standards, AS 10 "Accounting for Fixed assets" and AS 6 "Depreciation Accounting" which are applicable to the entities who are not required to comply with the *relevant Revised AS*. Both the categories of the Accounting Standards are

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collectively referred to as the “relevant applicable AS”.

4. The Guidance Note does not apply to audit of Investment Property and Intangible Assets.

5. In the event of a possible or perceived contradiction between the Guidance Note and a Standard on Auditing (SA) issued by the Institute, the Standard shall prevail.

### Introduction

6. The term *Property, plant and equipment in respect of those entities which are required to comply with the relevant Revised AS* refers to such tangible items that:

- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- (b) are expected to be used during more than one period.

In respect of such entities which need to apply AS 10 and AS 6, the term “Property, Plant and Equipment” comprises assets held for the purpose of providing or producing goods or services and which are not meant for sale in the normal course of business. Judgement is required to be exercised in recognizing what constitutes an item of property, plant and equipment having regard to an entity’s specific circumstances. For example, major spare parts, servicing equipment, and stand-by equipment, which an entity expects to use during more than one period, can be recognised as PPE as per the *relevant Revised AS*.

7. An asset can be classified as a PPE or otherwise, depending upon the use to which it is put or intended to be put. For example, assets which are classified as PPE in one type of business may be considered as current assets in another. Similarly, the same asset may be classified differently in an entity at different points of time. The recognition of Property, Plant and Equipment should be done as per the principles laid down in the “relevant applicable AS”.

8. PPE normally constitute a significant portion of the total assets, particularly in a manufacturing entity. Audit of PPE, therefore, assumes considerable importance.

9. The following features of PPE have an impact on the related audit procedures:

- (a) By their very nature, PPE are turned over much slower than current assets which are held for sale. Normally, PPE are carried over from year to year.
- (b) The average unit of PPE is normally of a relatively larger rupee value.
- (c) Since PPE are high value items, their acquisition is normally more closely

controlled. The control aspect assumes special significance where PPE are self-constructed.

- (d) PPE are generally accounted for once unlike other assets like stock, because of which any error would affect the financial statements permanently or at least for a significant period of time.
- (e) In an inflationary situation, where cost model is adopted, normally, the book values of PPE are considerably lower than their replacement values.

## **Risks Associated with Property, Plant and Equipment**

### **Inherent Risks**

10. The auditor needs to obtain an understanding of the client and its environment to consider inherent risk, including fraud risks, related to property, plant, and equipment. This includes:

- (a) Obtaining an understanding of the internal control over property, plant, and equipment. For example, preparation of and review of capital budgets, etc.
- (b) Assessing the risks of material misstatement and designing tests of controls and substantive procedures that cover the following aspects:
  - (i) Substantiate the **existence** of property, plant, and equipment. PPE may include assets that should have been derecognised following sale, other transfer of rights or abandonment. Auditor should verify title deeds, agreements or other ownership documents.
  - (ii) Establish the **completeness** of recorded property, plant, and equipment. Expenditure that should have been recognised as property, plant and equipment but has not been so recognized, including capitalised finance costs, failure to account for assets held under finance leases or hire purchase agreements.
  - (iii) Verify the **cutoff** of transactions affecting property, plant, and equipment.
  - (iv) Determine that the client has the **rights** to the recorded property, plant, and equipment.
  - (v) Establish the proper **valuation** or allocation of property, plant, and equipment and the **accuracy** of transactions affecting PPE.
  - (vi) Determine the correctness and appropriateness of classification of property, plant and equipment. For example, incorrect split between land and buildings or between long term and short term leaseholds. Classification may have a significant impact on the application of the

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accounting policies. As per relevant Accounting Standard, the entities have to follow the component approach, as may be applicable.

- (vii) *Depreciation value* - Depreciation may have been incorrectly calculated on account of factors such as:
- mechanical error; or
  - incorrect application of accounting policy; or
  - inappropriate assessment of remaining useful life; or
  - inappropriate assessment of residual value; or
  - incorrect classification of the asset.
- (viii) *Carrying cost* - Where a valuation model is followed - carrying amount may not reflect fair value due to factors including:
- failure to update valuations for current circumstances; or
  - failure to brief valuers correctly, use of invalid assumptions or data, etc., or
  - valuations not performed by competent personnel.
- (ix) *Existence / valuation* - tangible assets acquired in a business combination may not have been initially recognised at their fair value at that date.
- (x) *Value of impairment* - failure to recognise impairment or reversal of impairment.
- (xi) Determine that the ***presentation and disclosure*** of property, plant, and equipment are appropriate.

#### **Fraud Risks and Errors**

11. Some of the potential misstatements in PPE on account of frauds and errors include:

- (a) Purchase of an asset at an inflated price especially from a related party.
- (b) Wrong write-off of the asset as scrap, obsolescence, missing, donated, or destroyed.
- (c) Expenditures for repairs and maintenance recorded as PPE or *vice versa*.
- (d) Capitalisation of expenditure which are not normally attributable to the cost of the PPE.
- (e) Recording of an asset purchased, which in effect has not actually been received by the entity at all.

(f) Removal of an asset paid for by the entity or use of an asset of the entity for the benefit of a person other than the entity.

12. Such errors and frauds could occur because of weak internal controls in the entity including:

- (a) Inadequate involvement of management in overseeing employees with access to cash or other assets susceptible to misappropriation.
- (b) PPE which are small in size, marketable, or lacking observable identification of ownership.
- (c) Lack of complete and timely verification and reconciliations of assets.
- (d) Inadequate physical safeguards over PPE.
- (e) The misuse of the entity's assets by an employee.
- (f) Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).
- (g) The asset is intentionally sold below fair market value.

13. The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatements. These would include:

- (a) Inquiries of management and others within the entity to identify the risks. For example, control procedures, entity's objectives and strategies, incentive policies, etc.
- (b) Analytical procedures, for example, Ratios, etc.
- (c) Observation and inspection of the entity's premises and plant facilities.

### **Internal Controls**

14. An auditor should review the system of internal controls relating to PPE, particularly the following:

- (a) *Control over expenditure incurred on PPE acquired or self-constructed-* An effective method of exercising this control is capital budgeting, which, apart from ensuring proper authorisation of the expenditure incurred, also shows, in general, how effectively such expenditure is being controlled through periodical comparisons of actuals with budgeted figures. It also ensures that amounts expended do not exceed the amounts authorized, and controls allocation of expenditure between capital and revenue in the case of self constructed assets.

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- (b) *Accountability and utilisation controls* - Accountability over each PPE (or each class or component of PPE (in the case of companies following the *relevant Revised AS*)) is established, among other things, by maintaining appropriate records. This facilitates control over custodianship of such assets, for example, physical verification by the management or establishment of procedures relating to disposal of PPE. On the other hand, utilisation controls ensure that the individual PPE have been properly used for meeting the objectives of the entity.
- (c) *Information controls* - These controls ensure that reliable information is available for calculating and allocating depreciation, recording disposals or retirements, preparing tax returns, establishing the amount of insurance coverage, filing insurance claims, controlling repairs and maintenance charges or expenses incurred for inspection to assess the condition of the asset, replacement cost of specific parts, useful life of assets or specific parts, eg, specified number of hours of use, etc.
- (d) *Safeguarding of assets* - These controls ensure that the assets owned by the entity are safeguarded and any loss on damage / destruction of such assets are made good, through for example, insurance of assets, warranties, etc. The entity may have a process by which responsibility to safeguard the assets could be identified to specific personnel.

#### **Substantive Procedures**

15. Verification of PPE consists of examination of related records and physical verification. The auditor should, normally, verify the records with reference to the documentary evidence and by evaluation of internal controls. Physical verification of PPE is primarily the responsibility of the management.

16. The auditor must also consider the appropriateness of the accounting policies, including policies for determining which costs are capitalised, whether a cost or valuation model is followed and depreciation (including assessment of residual values) appropriately calculated.

17. As per the *relevant Revised AS*, the auditor should ensure that the entity has capitalised the assets as per the component approach, whereby a component or part of an asset which is significant in value compared to the total value of the asset or the useful life of which is different from that of the asset, has to be capitalised separately.

## **Verification of Records**

### ***Opening Balances***

18. The opening balances of the existing PPE should be verified from records such as the schedule of PPE, ledger or register balances. In the case of initial engagements, as per SA 510 (Revised), "Initial Audit Engagements – Opening Balances", for the purpose of ascertaining the accuracy of the opening balance of PPE, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances.

19. The auditor would also need to obtain summary of changes to PPE and reconcile the same to the ledgers.

### ***Capital Work in Progress***

20. The auditor must verify records to ensure that the assets under construction or pending installation and not yet ready for intended use are classified as work in progress.

21. Capital work in progress should be verified with reference to the underlying contractor bills, work orders, certification of work performed by independent persons, comparison of the progress and the costs incurred up-to-date with the budgets, capital asset management policy and plan, pending commitments, etc.

22. It must be ensured that an appropriate system is in place to capture all directly identifiable costs, which can be capitalized, to be so accumulated to the capital work in progress (WIP) whilst expenses which are not eligible for being capitalized are identified and charged to revenue in the normal course. The auditor should reconcile the movement of capital work in progress from opening to closing, specifically verifying additions during the year, capital assets completed during the years and impairment of any opening capital work in progress items. The closing work in progress value should be bifurcated asset class wise or project wise so that reconciliation of the capital WIP is made easier and more logical. The Capital work in progress should be reviewed with respect to the intention and ability of the management to carry forward and bring the asset to its state of intended use. The auditor should also specifically verify the date on which the assets are moved from the capital work in progress account to the fixed assets (the date on which the asset is ready for intended use), so that the depreciation on fixed assets may be computed correctly.

### ***Additions to PPE***

23. Acquisition of new PPE and improvements to the existing ones should be verified with reference to supporting documents such as orders, invoices,

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receiving reports and title deeds and applicable customs or excise documents. Due care needs to be taken when the purchase is from a related party. The auditor may employ procedures such as possible comparative prices prevalent in a ready market, evaluation, justification and approvals for the purchase.

24. Self-constructed PPE and improvements thereto should be verified with reference to the supporting documents such as contractors' bills, work-order records, installation certification, completion certificates and independent confirmation of the work performed.

25. The auditor should make appropriate enquiries and examine lease contracts to provide evidence that PPE acquired under finance leases or hire purchase agreements have been properly capitalized.

26. In respect of the additions to PPE during the year, the supporting documentation and information for the date on which the asset was put to use / was ready to use is required to be verified.

27. Assets acquired in exchange for a non monetary asset(s) should be verified with reference to the supporting documents for the commercial substance of the transaction (cash flows from the assets acquired against those given up) and the value of the asset given up.

28. The auditor should review expense accounts (e.g., Repairs and Renewals) to ascertain that new capital assets and improvements have not been included therein.

#### ***Ownership of PPE***

29. The ownership of assets, like land and buildings, may be verified by examining the title deeds. In case the title deeds are held by other persons, such as solicitors or bankers, confirmation should be, at least where significant, obtained directly by the auditors through a request signed by the client.

30. The auditor would also need to perform procedures to obtain corroborating evidence that the client actually possesses the rights associated with the assets under consideration. For example, the fact that the cash flows or economic benefits associated with it are actually accruing to the client.

#### ***Impairment of PPE***

31. The auditor needs to consider whether there are circumstances as per AS that indicate a possible impairment of property, plant and equipment and if such circumstances exist, how the same have been dealt with by the entity. Decline in the market value of assets, changes in technological, legal or economic environment in which the entity operates, evidence of physical damage of assets, are some indications of impairment.

***Deletions from PPE***

32. Where PPE have been written-off or fully depreciated in the year of acquisition/construction, the auditor should examine whether these were recorded in the PPE register before being written-off or depreciated.

33. In respect of PPE retired, i.e., destroyed, held for sale, scrapped or sold, the auditor needs to examine the following aspects, *inter alia*:

- (a) whether the retirements have been properly authorised and appropriate procedures for invitation of quotations have been followed wherever applicable;
- (b) whether the assets and depreciation accounts have been properly adjusted;
- (c) whether the sale proceeds, if any, have been fully accounted for; and
- (d) whether the resulting gains or losses, if material, have been properly adjusted and disclosed in the Profit and Loss Account.

34. It is possible that certain assets destroyed, scrapped or sold during the year have not been recorded. The auditor may use the following procedures to ascertain such omissions:

- (a) Review work orders/physical verification reports to trace any indicated retirements.
- (b) Examine major additions to ascertain whether they represent additional facilities or replacement of old assets, which may have been retired.
- (c) Make enquiries of key management and supervisory personnel.
- (d) Obtain a certificate from a senior official and/or departmental managers that all assets scrapped, destroyed or sold have been recorded in the books.

35. The auditor would also need to review the board minutes and other correspondence for indications of significant asset acquisitions, disposals or retirements.

36. Where there has been a change of use, the auditor would need to consider whether this gives rise to a need to change classification of the asset (eg, to inventory), assets held for sale, investment property, etc.

***Physical Verification***

37. It is the responsibility of the management to carry out physical verification of PPE at appropriate intervals in order to ensure that they are in existence. However, the auditor should satisfy himself that such verification was done by observing the verification being conducted by the management wherever

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possible and by examining the written instructions issued to the staff by the management and the relevant working papers. The auditor should also satisfy himself that the persons conducting the verification, whether the employees of the entity or outside experts have the necessary competence.

38. The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. SA 501, "Audit Evidence – Specific Considerations for Selected Items" contain principles related to the auditor's responsibilities and procedures in respect of attendance at physical inventory counting undertaken by the management. It would not be realistic to expect the management to suspend manufacturing operations for conducting a physical verification of the PPE, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land. Where the PPE can be moved and where verification of all assets cannot be conducted at the same time, they should be marked with distinctive numbers.

39. The auditor should apply appropriate emphasis on the verification of assets by the management of the assets which are outside the premises of the company, with third parties. This may be by way of a process of physical verification by the management or by way of obtaining confirmation from the third party holding the asset, depending on the management's risk assessment of such assets and the materiality of such assets.

40. The auditor should examine whether the frequency of verification was reasonable in the circumstances of each case. Where the assets are few and can be easily verified, an annual verification may be considered as reasonable. However, where the assets are numerous and difficult to verify, verification, say, once every three years by rotation - so that all assets are verified at least once in every three years – may be sufficient.

41. The auditor should test check the records of PPE with the physical verification reports. He should examine whether discrepancies noticed on physical verification

have been properly dealt with. In this regard the auditor should use his judgement as to whether having regard to the circumstances, the discrepancy is material enough to warrant an adjustment in the accounts and/or modification in the internal control system.

### **Recognition**

42. The auditor should ensure that the cost of an item of property, plant and equipment is recognised as an asset only when the costs have been reliably measured and it has been ascertained by the management that future economic benefits will flow to the entity.

43. The auditor should also verify that the entity has recognised a fixed asset in accordance with the generally accepted accounting principles applicable to the entity.

44. *Capital work in progress*: The auditor should verify that PPE under construction are recognized as capital work in progress until such time they are ready for intended use. The auditor should also verify that only those costs that could be capitalised are included under work in progress.

45. *Component approach*: As per the relevant revised AS, in the component approach of accounting for the PPE, the auditor should verify that the relevant PPE are capitalised as components where the useful life of the components significantly vary from the useful life of the entire asset (e.g., Cost of relining a furnace, aircraft seats which require replacement at regular intervals and, thus, have a varying useful life from the rest of the furnace or aircraft, respectively). Each major part of the item of PPE with a cost that is significant in relation to the total cost of the item is depreciated separately.

However, where the entity has originally not recognised a component separately, but subsequently replaces the part or a component, the auditor needs to verify that such replacements are capitalised only if the capacity or useful life of the asset increased, or quality of output improved or operating costs were reduced over and above that which was originally intended or estimated for the asset. The replaced part is derecognised.

### **Valuation**

#### **Carrying Cost of PPE**

46. The auditor should satisfy himself that the PPE have been valued in the financial statements according to the generally accepted bases of accounting and as per the applicable reporting framework which are determined by law,

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professional pronouncements of the Institute and the prevailing industry practices.

47. After initial recognition of the asset, in the case of subsequent measurement, the auditor should verify that the value of the asset is as per the model chosen by the entity as cost or revaluation model.

48. The auditor should also satisfy himself that the method by which the fair value has been determined is reasonable for the asset under consideration. For example, the market value method, income approach or the depreciated cost approach.

49. The auditor should also satisfy himself that the value has been determined with the help of a person competent to value the assets under consideration.

50. As per the *relevant Revised AS*, the auditor should verify that costs of major inspections, cost of spares used in connection with an asset and expected to be used for more than one period are added to cost of asset and derecognized earlier cost as per generally accepted accounting principles.

51. The auditor should consider whether the entity has reviewed the carrying value of its assets and how it determines the recoverable amount of the asset.

52. As per the *relevant Revised AS*, where several assets have been purchased for a consolidated price, the auditor should examine the method by which the consideration has been apportioned to the various assets. In case this has been done on the basis of an expert valuation, he should examine whether the same appears reasonable and based on adequate facts.

53. Where an entity owns assets jointly with others (otherwise than as a partner in a firm) the auditor should examine the relevant documents such as title deeds, agreements, etc., in order to ascertain the extent of the entity's share in such assets. The assets are used to obtain benefits for the entity and /or the entity recognizes its share of the assets. The auditor needs to verify the underlying agreements and the benefits which the entity receives or expects to receive as per generally accepted accounting principles.

54. As per the *relevant Revised AS*, where the entities have obligations to dismantle, remove and restore items of property, plant and equipment, the cost of an item of plant and equipment have to include such costs. The auditor should examine the method and process of identification, estimation and treatment of such costs based on the model in which the asset is measured in accordance with the generally accepted accounting principles.

55. The auditor must ensure that the cost of self constructed assets include all

the items of costs which are to be capitalized including specific direct expenses related to the asset and appropriate borrowing costs.

56. As per the *relevant Revised AS*, the auditor should ensure that the cost of self constructed assets do not include cost of abnormal wastage of material labour or other resources.

57. As per the *relevant Revised AS*, the auditor should also verify the payment towards the assets beyond the normal credit terms to confirm the cost which can be capitalized.

### **PPE Acquired on/or as Government Grants**

58. When the entity acquires land or other fixed assets as government grants at concessional rates, then the entity has to account for such assets at the acquisition cost. In case the asset is acquired free of cost, it should be accounted at nominal value.

59. The grant can be shown as a deduction from the gross value of assets or the asset can be shown in the balance sheet at the net value.

60. Entity following *relevant Revised AS* should capitalise the assets at the full value and account for the grant according to the relevant applicable Standard.

### **Depreciation**

61. The auditor should test check the calculations of depreciation and the total depreciation arrived at should be compared with that of the preceding years to identify reasons for variations. He should particularly examine whether the depreciation charge is adequate keeping in view the generally accepted bases of accounting for depreciation.

62. As per the *relevant Revised AS*, the auditor must check that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. Such part of an item may also have different useful life over which the asset is to be depreciated. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

63. The auditor should review the depreciation method applied to the asset at least at the end of each financial year to confirm that the depreciation charge reflects the usage. A change in the method of depreciation should be treated appropriately as a change in an accounting estimate.

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64. The auditor must verify that those assets under construction or installation are not depreciated until such time they are ready for intended use but these should be tested for impairment, if any.

#### **Useful Life of PPE**

65. The auditor should ensure that the management has reviewed the useful life and the residual value of the asset at least annually. The useful life is, ordinarily, estimated based on the future economic benefits embodied in the asset or such other factors prescribed by the Standard or the asset management policy of the entity.

#### **Impairment of PPE**

66. An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. If the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount.

67. The auditor should enquire whether any compensation is receivable from third parties for items of PPE which are impaired, lost or given up and credit the same to the Profit & Loss Account when the amount becomes receivable.

68. An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss.

69. The increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

#### **Revaluation of PPE**

70. Revaluation of PPE implies restatement of their book values on the basis of systematic scientific appraisal which would include ascertainment of working condition of each unit of PPE, technical estimates of future working life and the possibility of obsolescence. This is done where the fair value of the asset can be reliably measured. As per SA 620 (Revised), "Using the Work of an Auditor's Expert", if expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor needs to determine whether to use the work of an auditor's expert. For example, an expert may be

used for valuation of land and buildings or plant and machinery. Such an appraisal is usually made by independent and qualified persons such as engineers, architects, etc. To the extent possible, the auditor should examine these appraisals. As long as the appraisals appear reasonable and based on adequate facts, he is entitled to accept the revaluation made by the experts.

71. Where valuation is performed internally, the auditor should consider the basis on which it was done, the adequacy of the evidence obtained to support the valuation and the overall reasonableness of the result.

72. The auditor must also satisfy himself that the frequency of revaluation is adequate and appropriate so that the fair value of the revalued asset does not materially differ from the carrying value of the asset.

73. The auditor should verify the basis of de-recognition and the accounting treatment of an asset on disposal or when no future economic benefits are expected from its use.

### **Disclosure**

74. The auditor should verify that the entity has made relevant disclosures for PPE (or class of PPE) on depreciation methods, measurement bases, details of additions and deletions, the existence of rights and restrictions, carrying amount during the course of construction, contractual commitments, impairment of assets, revaluation of assets, etc, as per the Standards applicable to the entity.

### **Audit in IT environment**

75. The auditor needs to check the controls based on the use of manual or automated elements which affect the manner in which transactions are initiated, recorded, processed and reported. The IT environment benefits the entity by:

- (i) Providing consistency in application of pre defined policies. For example, application of depreciation rate based on asset classification or useful life.
- (ii) Enhancing timeliness and accuracy of information, for example, monthly account closure procedures like passing depreciation entries.
- (iii) Generating analytical information, for example, Ratios, comparative information, etc.
- (iv) Reducing risks that controls can be circumvented, for example, authorisation for purchase of fixed assets.

76. The IT environment, however, may pose control threats like:

- (i) Reliance on systems which may inaccurately process data.

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- (ii) Unauthorised access to data leading to data loss or destruction. For example, the Fixed Assets Register may be tampered with by other personnel.
  - (iii) Unauthorised changes to data in master file.
  - (iv) Inappropriate manual intervention.
  - (v) Inability to access data as required.
77. The auditor needs to determine that the automated control is functioning as intended. Subsequently, the following also need to be verified:
- (a) That the changes to programs are subject to controls.
  - (b) That the authorised version of the program is used.
  - (c) Other general controls.
  - (d) Inspection of the record of administration of IT.

## GUIDANCE NOTE ON AUDIT OF INVENTORIES\*

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*The following is the text of the Guidance Note on Audit of Inventories, issued by the Auditing Practices Committee (APC)\*\* of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.*

1. Para 2.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Inventories, Chapter 5 of the *Statement on Auditing Practices*, titled "Inventories", shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.

### Introduction

3. Inventories are tangible property held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumable stores and spare parts meant for replacement in the normal course.<sup>1</sup> Inventories normally comprise raw materials including components, work-in-

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\* Issued in November, 1994.

\*\* Now known as the Auditing and Assurance Standards Board (AASB).

<sup>1</sup> Servicing equipment, stand-by equipment and specialised spares of machinery (which are in the nature of 'insurance spares') are normally capitalised.

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process, finished goods including by-products, maintenance supplies, stores and spare parts, and loose tools.<sup>2</sup>

4. Inventories normally constitute a significant portion of the total assets, particularly in the case of manufacturing and trading entities as well as some service rendering entities. Audit of inventories, therefore, assumes special importance.

5. The following features of inventories have an impact on the related audit procedures:

- (i) By their very nature, inventories normally turn over rapidly.
- (ii) Inventories are susceptible to obsolescence and spoilage. Further, some of the items of inventory may be slow-moving while others may follow a seasonal pattern of movement.
- (iii) Inventories are normally movable in nature, although there may be some instances of immovable inventories also, e.g., in the case of an entity dealing in real-estate.
- (iv) All the items of inventory may not be located at one place but may be held at different locations such as factories and warehouses, or with third parties such as selling agents.
- (v) The individual items of inventory may not be significant in value, but taken together, they normally constitute a significant proportion of total assets and current assets of manufacturing, trading and certain service entities.
- (vi) Physical condition (e.g., stage of completion of work-in-process in certain industries) and existence of certain items of inventories may be difficult to determine.
- (vii) Valuation of inventories may involve varying degrees of estimation, including expert opinions, e.g., in the case of jewellery.

### **Internal Control Evaluation**

6. The auditor should study and evaluate the system of internal control relating to inventories, to determine the nature, timing and extent of his other audit

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<sup>2</sup> The audit procedures, relating to shares debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are similar to those followed for audit of investments. Accordingly, this Guidance Note does not apply in respect of audit of shares, debentures and other securities held as stock-in-trade.

procedures. He should particularly review the following aspects of internal control relating to inventories<sup>3</sup>:

- (a) The control procedures should provide for segregation of such functions whose combination may permit the commitment or concealment of fraud or error; for example, persons undertaking the physical verification of stocks should be different from those responsible for store-keeping in respect of those stocks.
  - (b) The stores procedures should provide for the use of pre-numbered standardized forms.
  - (c) There should be a system of cross-checking the data generated by different operating departments.
7. The auditor should also review specific controls over receipts, issues, physical inventories, and inventory records.

## **Verification**

8. As in the case of other assets, the responsibility for properly determining the quantity and value of inventories rests with the management of the entity. It is, therefore, the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all inventories owned by the entity. The management satisfies this responsibility by carrying out appropriate procedures which will normally include verification of all items of inventory at least once in every financial year. This responsibility is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence.

9. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices (SAP) 5, Audit Evidence). In carrying out an audit of inventories, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Existence that all recorded inventories exist as at the year-end.

Ownership that all inventories owned by the entity are recorded and that all recorded inventories are owned by the entity.

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<sup>3</sup> The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative discussion on internal controls in relation to inventories.

## **III.20 Auditing Pronouncements**

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Valuation that the stated basis of valuation of inventories is appropriate and properly applied, and that the condition of inventories is recognised in their valuation.

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

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

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor.

### **Examination of Records**

10. The entities usually maintain detailed stock records in the form of stores/stock ledgers showing in respect of each major item, the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case.

11. The auditor may come across cases where the entity does not maintain detailed stock records other than the basic records relating to purchases and sales. In such situations, the auditor would have to suitably extend the extent of application of the audit procedures discussed in paragraphs 12-22 and 30.

### **Attendance at Stock-taking**

12. Physical verification of inventories is the responsibility of the management of the entity. However, where the inventories are material and the auditor is placing reliance upon the physical count by the management, it may be appropriate for the auditor to attend the stock-taking. The extent of auditor's attendance at stock-taking would depend upon his assessment of the efficacy of relevant internal control procedures, and the results of his examination of the stock records maintained by the entity and of the analytical review procedures.

13. The procedures concerning the auditor's attendance at stock-taking depend upon the method of stock-taking followed by the entity.

14. There are two principal methods of stock-taking : periodic stocktaking and continuous stock-taking. Under the first method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date before or shortly after the year-end. Under the second method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous stock-taking method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous stock-taking methods for certain stocks and carry out a full count of other stocks at a selected date.

15. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. Before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. An illustrative set of instructions which may be useful in most cases is given in Appendix I to this Guidance Note.

16. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those stocks which have a high value either individually or as a category of stocks. Proper attention should also be paid to the physical condition of inventories.

17. Ideally, there should be no movement of stocks when the physical verification is being carried out. On occasions, however, it may be necessary for the entity to continue the production, receiving, or dispatch operations during physical verification. In such circumstances, it is essential that the entity has the procedures to identify and record such movements. The auditor should review the procedures adopted by the entity to account for the movement of inventories from one location to another within the entity during stock-taking (e.g., issues from stores to production departments).

18. The auditor should also examine whether the entity has instituted appropriate cut-off procedures to ensure that –

### **III.22 Auditing Pronouncements**

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- (a) goods purchased but not received have been included in the inventories and the liability has been provided for;
- (b) goods sold but not despatched have been excluded from the inventories and credit has been taken for the sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking.

19. The auditor should review the original physical verification sheets and trace selected items including the more valuable ones into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, e.g., stock statements submitted to banks.

20. The auditor should examine whether the discrepancies noticed on physical verification have been investigated and properly accounted for.

21. Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed in paragraphs 16-20 above, pay greater attention to ascertaining whether the management:

- (a) maintains adequate stock records that are kept up-to-date;
- (b) has satisfactory procedures for physical verification of inventories, so that in the normal circumstances the programme of physical verification will cover all material items of inventories at least once during the year; and
- (c) investigates and corrects all material differences between the book records and the physical counts.

22. The auditor should determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items of inventory are well-designed and operate properly.

### **Confirmations from Third Parties**

23. Where significant stocks of the entity are held by third parties, the auditor should examine that the third parties are not such with whom it is not proper that the stocks of the entity are held. The auditor should also directly obtain from the third parties written confirmation of the stocks held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. A proforma letter of request for confirmation to be used in such cases is given in

Appendix II to this Guidance Note. Similarly, the auditor should also obtain confirmation from such third parties for whom the entity is holding significant amount of stocks. Appendix-III to this Guidance Note gives a proforma letter of request for confirmation to be used for this purpose.

### **Examination of Valuation and Disclosure**

24. The auditor's objective concerning valuation is to obtain evidence that the amount at which inventories have been valued is computed on an appropriate basis.

25. The auditor should satisfy himself that the valuation of inventories is in accordance with the normally accepted accounting principles and is on the same basis as in the preceding year. The generally accepted accounting principles<sup>4</sup> involved in the valuation of most types of inventories are dealt with in Accounting Standard (AS) 2, "Valuation of Inventories", issued by the Council of the Institute of Chartered Accountants of India.

26. The auditor should examine the methods of applying the basis of inventory valuation. Thus, with regard to determination of cost, the auditor should examine, *inter alia*, the stock sheets, records of physical verification, invoices, costing records and other relevant documents and also examine and test the treatment of overhead expenses as a part of cost of inventories.

27. Wherever feasible, and particularly where only a single or a few major products are produced, the auditor may call for a reconciliation of the total cost of production for the year as determined by the cost records with the total expenses as per the financial books and review this reconciliation. Where standard costs are used or where overheads are charged at standard rates or percentages, he may examine the variances from actuals and, where these are significant; ensure that appropriate adjustment is made to the inventories.

28. The auditor should examine the evidence supporting the assessment of net realizable value. In this regard, the auditor should particularly examine whether appropriate allowance has been made for defective, damaged and obsolete and slow-moving inventories in determining the net realizable value.

29. The auditor should satisfy himself that the inventories have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

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<sup>4</sup> It may be mentioned that the Manufacturing and Other Companies (Auditor's Report) Order, 1988 uses the words "normally accepted accounting principles".

#### **Analytical Review Procedures**

30. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to inventories:

- (i) reconciliation of quantities of opening stocks, purchases, production, sales and closing stocks;
- (ii) comparison of closing stock quantities and amounts with those of the previous year;
- (iii) comparison of the relationship of current year stock quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;
- (iv) comparison of the composition of the closing stock (e.g., raw materials as a percentage of total stocks, work-in-process as a percentage of total stocks) with the corresponding figures for the previous year;
- (v) comparison of current year gross profit ratio with the gross profit ratio for the previous year;
- (vi) comparison of actual stock, purchase and sales figures with the corresponding budgeted figures, if available;
- (vii) comparison of yield with the corresponding figure for the previous year;
- (viii) comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;
- (ix) comparison of significant ratios relating to inventories with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out audit of inventories. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

#### **Special Considerations in Case of Work-In-Process**

31. In general, the audit procedures regarding work-in-process are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-process for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (e.g., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary.

32. In certain cases, due to the nature of the product and the manufacturing process involved, physical verification of work-in-process may be impracticable. In such cases, the auditor should lay greater emphasis on ascertaining whether the system, from which the work-in-process is ascertained, is reliable. It may also be useful for the auditor to examine the subsequent records of production/sales.

### **Management Representations**

33. The auditor should obtain from the management of the entity, a written statement describing in detail, the location of inventories, methods and procedures of physical verification and valuation of inventories. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to inventories, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding inventories is given in Appendix IV to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in a composite representation letter usually issued by the management to the auditor.

### **Documentation**

34. The auditor should maintain adequate working papers regarding audit of inventories. He should maintain on his audit file a summary of each inventory as also the details regarding the extent of his verification. The management representation letter concerning inventories should also be maintained on the audit file.

## ***Appendix I***

### **Illustrative Set of Instructions to be Issued by the Client to its Staff Responsible for Stock-Taking**

*(Ref. Paragraph 15)*

*This Appendix contains an illustrative set of instructions which may be issued by the client to the staff responsible for stock-taking. The Appendix also lists special instructions in respect of stocks held by others and work-in process.*

The annual physical examination of inventories of the entity is to be carried out on 31st March. The work will commence at 8.00 A.M. on 31st March, and there will be no movement of inventories during their physical examination.

1. Mr. AB will be in overall charge of the physical counting.

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2. Messrs....., Auditors, will depute their staff to observe the work performed by us. It should be remembered that they are not responsible for any part of the stock-taking.
3. You are responsible for the physical counting of all stocks in (state here the exact area for which the person is responsible e.g., Block B of Godown No. 2, or in the open yard on south of factory, etc.). You are not concerned with similar items of stock which may be stored at other locations.

#### **How to proceed with the work**

4. At 8 A.M. you should present yourself in the office of Mr. AB where you will be handed over a bunch of inventory tags. You should ensure that you have in your possession a sufficient number for your needs. You should also have in your possession a pen, blank papers, a measuring tape, ..... (state here any other instrument which is required for measurement, counting, weighing etc.). Please ensure that for all items in your area for which weighing or measuring is required, the necessary apparatus is available.

#### **Procedure for tagging**

5.1 You should place a tag on each pile, box, bin, etc., which is counted by you after recording the quantity, description, part number, condition of the stocks to the extent known (e.g., damaged stocks), etc., on the tag. You should proceed in proper order so as to ensure that no items are omitted. When the work of counting is completed you should hand over the remaining tags including soiled and damaged tags to Mr. PQ.

5.2 All items are required to be measured, weighed or counted in order to ascertain the exact quantity on hand. However, in respect of small items of in significant value, such as bolts, nuts (state here any other items which are known to be of small value), the quantities on hand may be estimated without actual counting etc. In the latter case, please state "estimated" on the tag.

5.3 Please ensure that proper identification is made by part number, description, etc., and that in the case of work-in-process, the last operation performed is clearly specified in accordance with the schedule attached to this Memorandum. No movement of any stock from one location to another should take place during the period of stock checking.

5.4 Where bin cards are kept on the bins or job tickets are attached to items in process, you should not merely copy the quantities shown on those documents to the tag without verification. All alterations made on the tags should be initialled and quantities should be recorded in ink.

5.5 Mr. PQ is responsible for the control over tags in use. For this purpose, he should prepare a schedule in the attached Form.

5.6 After obtaining the permission of the auditors<sup>5</sup>, instructions will be issued for the removal of the tags and a suitable person should be sent around in each department to detach the detachable portion of the tags, leaving the counterpart in the proper position. When they are collected, all such tags should be brought back to a central location, placed in serial order and tallied with the schedule prepared by Mr. PQ. After this has been done, the tags will be released to the Accounts Department which is concerned with the preparation of the inventory. Later on, when the inventory has been prepared, a check should be possible to see whether all the tags have been listed.

5.7 After the work of counting has been completed, Mr. AB, who is in overall charge of stock-taking, will make a visit to each area in order to ascertain that all bins, boxes, etc., bear a tag and make a check of the quantities shown therein. At this point, the auditors will carry out further observation and make such test checks as they consider necessary.

5.8 The counterparts of the tags should be left on the relevant bins or piles for a period of at least one month and the quantity shown on the counterparts of the tag should be used as the opening balance of the bin card for the subsequent period.

### **Procedure for preparing stock sheets**

6.1 Separate listings under the following broad heads should be prepared:

- (i) Raw materials, including components
- (ii) Work-in-process
- (iii) Finished goods, including by-products
- (iv) Maintenance supplies and stores and spare parts
- (v) Loose tools

Defective, damaged, obsolete, excess or slow-moving stocks should be listed separately under each of the above categories.

6.2 It should be examined that the stock cards, bin cards, tags or other stock records are posted up-to-date so that items can be traced and verified in these records, simultaneously with the physical checking of stocks.

6.3 A list of excesses and shortages should be drawn up at the time of physical stock-taking.

6.4 Stocks belonging to third parties and remaining in custody of the entity should be separately identified from the entity's own stock. A separate listing should be prepared for all such items of stocks.

6.5 Defective, damaged, obsolete, excess or slow-moving stocks should be kept separate from other items.

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<sup>5</sup> It is presumed that the auditors or their representatives are present at the time of stock-taking.

### III.28 Auditing Pronouncements

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6.6 Counters and checkers should sign or initial the stock sheets for the work done by them.

#### Stocks held by others

7.1 The following steps be taken for stocks belonging to the entity but held by others:

- (i) A separate listing for such stocks be prepared.
- (ii) A letter should be sent to such persons to confirm the stocks held by them directly to the auditor.
- (iii) An authority to inspect stocks held by third parties should be given to the auditor where the same is considered necessary by the auditor.
- (iv) An independent record for such goods be kept by the entity.

7.2 The above steps should also be taken for stocks given on loan or received on loan.

#### Work-in-Process

8.1 With regard to work-in-process, the following instructions be given to the staff members concerned:

- (i) A separate listing for work-in-process be prepared.
- (ii) The internal records kept by the entity be written up-to-date.
- (iii) If the amount of work-in-process is determinable from production records, the same be kept up-to-date.
- (iv) A list of opening work-in-process be kept ready at the time of stock-taking.

## Appendix II

### Illustrative Letter of Confirmation of Inventories Held by Others

*[Ref. Paragraph 23]*

***(Letterhead of Entity)***

[Date]

[Name and address of holder of inventories]

Dear Sir,

For audit purposes, kindly furnish directly to our auditors (name and address of the auditors) details concerning our inventories held by you for [state here the purpose of holding of inventories by the third party] as of the close of business on .....

According to our records, you held the following inventories as of that date:

Description	Quantity
-------------	----------

.....  
.....

In case you identify certain items of inventories as defective or damaged, the details thereof may be furnished separately, indicating the quantities and giving a general description of the condition of such items. Also, please confirm that our inventories held by you are free of any charge or encumbrance.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

### ***Appendix III***

#### **Illustrative Letter of Confirmation – Inventories Held by the Entity on Behalf of Others**

*[Ref. Paragraph 23]*

[Letterhead of Entity]

[Date]

[Name and address of owner of inventories]

Dear Sir,

For audit purposes, kindly furnish directly to our auditors (name and address of the auditors) details concerning your inventories held by us for [state here the purpose of holding of inventories by the entity as of the close of business on \_\_\_\_\_].

According to our records, we held the following inventories as of that date:

Description	Quantity
.....	.....
.....	.....

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

**Representation Letter for Inventories**

*[Ref. Paragraph 33]*

The following is a sample representation letter for inventories. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X limited as of....., 19..., and for the year then ended, we make, to the best of our knowledge and belief, the following representations concerning inventories.

1. Inventories at the year-end consisted of the following:

Raw Materials (including components)	✓ _____
Work-in-Process	✓ _____
Finished Goods (including by-products)	✓ _____
Maintenance supplies and Stores and Spare Parts	✓ _____
Loose Tools	✓ _____
Others (specify each major head separately)	✓ _____
Total	✓ _____

2. All quantities were determined by actual physical count or weight or measurement that was taken under our supervision and in accordance with written instructions, on ..... (date/dates of physical verification), except as follows:<sup>6</sup>

.....  
.....

3. Except as set out below, all goods included in the inventory are the property of the entity and are not subject to any charge, and none of the goods are held as consignee for others or as bailee:

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<sup>6</sup> Where physical verification of inventories is carried out at a date other than the closing date, this paragraph may be modified as below:

Inventories recorded in the books as at.....(date of balance sheet) aggregating to ` ..... are based upon the physical inventories taken as at ..... (date of physical verification) by actual count weight or measurement. The material discrepancies noticed on physical verification of stocks as compared to book records have been properly dealt with in the books of account and subsequent transactions recorded in the accounts fairly reflect the changes in the inventories up to ..... (balance sheet date).

.....

.....

4. All inventories owned by the entity, wherever located, have been recorded, including goods sent on consignment.

5. Inventories do not include goods sold to customers for which delivery is yet to be made.

6. Inventories have been valued on the following basis/bases:

- Raw Materials (including components)
- Work-in-Process
- Finished Goods (including by-products)
- Maintenance supplies and Stores and Spare Parts
- Loose Tools
- Others (specify each major head separately)

(In describing the basis/bases of valuation, the method of ascertaining the cost (e.g. FIFO, Average Cost or LIFO) should also be stated. Similarly, the extent to which overheads have been included in the cost should also be stated.)

7. The following provisions have been made in respect of excess, slow moving, damaged, or obsolete inventories and these, in our view, are adequate.

.....

.....

8. No item of inventories has a net realizable value in the ordinary course of business which is less than the amount at which it is included in inventories.

9. The basis/bases of valuation is/are the same as that/those used in the previous year, except as set out below:

Class of Inventory	Basis of valuation		Effect of change in Basis of Valuation
	This year	Last year	
.....	.....	.....	.....
.....	.....	.....	.....

Yours faithfully,

(Signature of responsible official of the entity)

#### Clarification<sup>7</sup>

#### **Auditor's Duties where Inventories are Stated to be "As Valued and Certified by the Management" in Financial Statements**

*(Refer Paragraph 33)*

It has been observed that in some cases, inventories are described in the financial statements as "Stocks (as valued and certified by the management)". The use of such an expression may lead the users of the financial statements to believe that the auditor merely relies on the management's certificate without carrying out any other appropriate audit procedures to satisfy himself about the existence and valuation of inventories.

The Institute of Chartered Accountants of India has issued a Guidance Note on Audit of Inventories, which recommends the procedures to be followed by the auditors in conducting the audit of inventories. Para 33 of the Guidance Note, *inter alia*, recommends as below:

*"The auditor should obtain from the management of the entity, a written statement describing in detail the location of inventories, methods and procedures of physical verification and valuation of inventories. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to inventories, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information."*

In view of the above, the Council of the Institute hereby clarifies that despite the expression "as valued and certified by the management", the duties and responsibilities of the auditors with regard to audit of inventories are not diminished. Thus, in order that the auditor's role with regard to inventories is properly appreciated by the users of the financial statements, the auditor may advise his clients to omit the words "as valued and certified by the management", when describing inventories in the financial statements.

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<sup>7</sup> Published in September, 1999 issue of "The Chartered Accountant", p.66.

## **GUIDANCE NOTE ON AUDIT OF INVESTMENTS\***

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*The following is the text of the Guidance Note on Audit of Investments issued by the Auditing Practices Committee (APC)\*\* of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.*

1. Para 2.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.
2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee, It is intended to issue, in due course of time, SAs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn.<sup>1</sup> With the issuance of this Guidance Note on Audit of Investments, Chapter 4 of the *Statement on Auditing Practices*, titled "Investments", shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.

### **Introduction**

3. Investments are assets held by an entity for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing

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\* Issued in November, 1994.

\*\* Now known as the Auditing and Assurance Standards Board (AASB).

<sup>1</sup> This Guidance Note does not deal with special aspects of audit of investments of retirement benefit plans, life insurance enterprises, mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956. The special aspects of audit of investments of some of these institutions have been dealt with in other publications of the Institute, e.g., *Guidance Note on Audit of Banks*, *Guidance Note on Audit of Companies Carrying on General Insurance Business*, *Guidance Note on Companies Carrying on Life Insurance Business*. It may also be noted that in the case of certain types of entities, e.g., companies, banks, insurance companies, co-operative societies, etc., the question of compliance with the legal requirements assumes special importance. Appendix I to this Guidance Note contains a brief description of the main provisions of the statutes governing these types of entities in so far as they relate to investments. It may be emphasised that the Appendix is only illustrative and not exhaustive. Moreover, the legal requirements may change from time to time and, therefore, this Appendix should not be construed as representing the correct legal position at all points of time.

### III.34 Auditing Pronouncements

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entity<sup>2</sup> Investments are classified as 'current investments' and 'long term investments'. A *current investment* is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A *long term investment* is an investment other than a current investment.<sup>3</sup>

4. The following features of investments have an impact on the related auditing procedures:

- (a) Investments constitute a significant portion of the total assets of certain entities like banks, insurance companies, investment companies, trusts, etc. In other cases, the nature, quantum and type of investments may vary from case to case.
- (b) Documentary evidence is generally available for audit verification. A detailed record of acquisition, disposal, etc., of the investments is usually maintained.
- (c) The market values of investments may keep on fluctuating. While in the case of some investments, such fluctuations may not be wide, in the case of others, they may be significant.
- (d) Physical location of documents of title to investments may be different from the one where the acquisition, disposal and recording thereof take place.
- (e) Many investments are readily marketable or can be converted into cash.

### Internal Control Evaluation

5. The auditor should study and evaluate the system of internal control relating to investments to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to investments.<sup>4</sup>

- (a) *Control over acquisition, accretion and disposal of investments*: There should be proper authority for sanction, acquisition and disposal of investments (including renunciation of rights). It should also be ensured that investments are made in

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<sup>2</sup> It may be clarified that the term 'investments' covers only to such securities as are beneficially owned by the entity and not those held by it on behalf of others.

<sup>3</sup> It may be clarified that inventories, as defined in Accounting Standard (AS) 2, *Valuation of Inventories*, issued by the Institute of Chartered Accountants of India are not investments. However, the recommendations of this Guidance Note also apply, to the extent relevant to shares, debentures and other securities held as stock-in-trade. Fixed assets (other than investment properties), as defined in Accounting Standard (AS) 10, *Accounting for Fixed Assets*, issued by the Institute, are also not investments.

<sup>4</sup> The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the *Internal Control Questionnaire*, issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to investments.

accordance with the legal requirements governing the entity as also with its internal regulations, e.g., the provisions of the articles of association, rules and regulations, trust deed, etc.

- (b) *Safeguarding of investments:* The investments should be in the name of the entity as far as possible. The legal requirements in this behalf, if any, should be complied with. There should exist a proper system for the safe custody of all scrips or other documents of title to the investments belonging to the entity.
- (c) *Controls relating to title to investments:* It should be ensured that in cases where the title does not pass on to the entity immediately on acquisition, the same is transferred to the entity in due course of time, along with the benefits that might have accrued since the acquisition of the investments. It should be ensured that there is no undue time-lag in the execution of various stages of the transactions.
- (d) *Information controls:* These controls should ensure that reliable information is available for recording acquisitions (including by way of conversion of securities, right issues or other entitlements, under schemes of amalgamation, acquisition, etc.), accretions and disposals, and for ascertaining the market values etc. Detailed records regarding acquisition, disposal etc. of the investments should be maintained along with proper documentation.

## **Verification**

6. The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Verification of investments may be carried out by employing the following procedures:

- (a) verification of transactions;
- (b) physical inspection;
- (c) examination of valuation and disclosure; and
- (d) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgment of the auditor.

7. The investments of an entity may take various forms, e.g., they may be in the form of Government securities, shares and debentures, immovable properties, etc. The following paragraphs discuss the audit steps for verifying investments, with

### **III.36 Auditing Pronouncements**

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special reference to investments in the form of shares, debentures and other securities.

#### **Verification of Transactions**

8. The auditor should ascertain whether the investments made by the entity are within its authority. In this regard, the auditor should examine whether the legal requirements governing the entity, insofar as they relate to investments, have been complied with and the investments made by the entity are not *ultra vires* the entity. Apart from the above, the auditor should also 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 entity.

9. The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence. The auditor should pay special attention to ascertaining whether the investments have been purchased or sold cum-dividend/ex-dividend, cum-interest/ex-interest, cum-right/ex-right or cum-bonus/ex-bonus. He should check whether proper adjustments in this regard have been made in the cost/sales value of securities purchased or sold.

10. In the case of a rights issue, the offer to the entity contained in the letter of rights should be examined. Where the rights have been renounced or otherwise disposed of or not exercised, the auditor should examine the relevant decision of the appropriate authority in this behalf, as also that the sale proceeds, if any, have been duly accounted for.

11. As regards bonus shares, the intimation to the entity regarding such issue should be examined with a view to ascertaining the receipt and recording of the requisite number of shares by the entity.

12. Where the amounts of purchases or sales of investments are substantial, the auditor may check the prices paid/received with reference to the stock exchange quotations, where available, on or about the date of purchase or sale.

#### **Physical Inspection**

13. The auditor should carry out a physical inspection of investments in the form of shares, debentures and other securities. (Special considerations apply in the case of investments in the form of immovable properties, as discussed in paragraph 24.) In the case of certain entities (e.g., insurance companies), physical inspection of investments is a statutory requirement.

14. The depository services and scripless trading are becoming increasingly popular in India. Depository services involve custody of documents of title to investments such as certificates, scrips and deeds and thus avoid their physical handling by the investor. The Public Debt Office of the Reserve Bank of India offers such services to facilitate trading in Government Securities. Authorised institutions such as banks, financial institutions etc., which have individual ledger accounts with the Public Debt Office can trade in government securities between themselves by issuing and accepting Bankers' Receipts. In case of such transactions, the auditor should verify the periodic reconciliation of balances as per the records of the entity and those as per the Public Debt Office.

15. Apart from the Public Debt Office, there are now a number of other custodial organisations whose services are being utilised by banks, large investors, institutional investors, mutual funds etc. The concept of the National Depository System (NDS) is also under development. This system is aimed at eliminating physical movement of securities for purchases and sales. Wherever the services of any of these custodial or depository organisations are being used by the entity under audit, the auditor should redesign his audit procedures to ensure that there is an effective system of periodic reconciliation of balances as per the records of the entity and those as per the records of the custodial or depository organisation. The auditor should also examine the certificates issued by such organisations confirming the holdings of the entity. The concept of scripless trading being introduced by the National Stock Exchange and the OTC Exchange of India also envisage elimination of movement of title deeds of securities. In such cases, the auditor should verify the interim and other acknowledgments issued by dealers as well as the year-end confirmation certificates of the depository organisations.

16. The investments held by the entity in its own custody should normally be examined at the close of business on the last day of the year. In case this is not possible, the auditor should carry out the inspection on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc. Where a substantial number of investments are kept by the entity in its custody, the auditor should carry out a surprise inspection of the investments on hand at least once in the year in addition to his year-end examination. He should take particular care to see that only the investments belonging to the entity are produced to him. This aspect assumes special importance in the case of entities like banks which hold investments on their own account, in the form of securities

### **III.38 Auditing Pronouncements**

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lodged by the customers against loans and advances, and on behalf of the PMS clients.

17. Where investments are held by any other person on behalf of the entity, e.g., by banks, the auditor should examine the certificates received from them. Such certificates should preferably be received directly by the auditor. A suggested form of bank confirmation certificate is given in Appendix II to this Guidance Note.

18. In case investments are held by persons other than banks, the auditor should ensure that there is justification for it, e.g., securities in the custody of brokers or with the company concerned for transfer, consolidation, splitting up conversion, etc. Evidence of securities held with others should be examined and, in appropriate cases, physical inspection of the relevant documents may be made, to the extent possible, in the course of audit. Where the investments are recorded at an office other than the one where the documents of title thereto are physically located, the local auditor may be requested to verify the same.

19. If the investments are held otherwise than in the name of the entity (e.g., in the name of nominees/trustees), the auditor should ascertain the reasons for the same and examine the relevant documentary evidence (e.g., written confirmations from the nominees, trustees, etc.) supporting the real/beneficial interest of the entity in the investments.

20. The auditor should also examine any other aspects required to be examined or reported upon by the relevant statute. For example, in the case of a company, the auditor should also carry out the procedures outlined in paragraphs 21-23 below.

21. Where shares are held not in the name of the company but in the name of a director, officer, etc., the auditor should examine whether the declaration referred to in section 187-C of the Companies Act, 1956 has been properly made.

22. The auditor should keep in mind the provisions of section 227(1A)(c) which requires that the auditor of a company, not being an investment company within the meaning of section 372 of the Companies Act, 1956 or a banking company, should enquire whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they are purchased by the company.<sup>5</sup>

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<sup>5</sup> For a detailed discussion on this aspect reference may be made to the *Statement on Qualifications in Auditor's Report*, issued by the Institute of Chartered Accountants of India.

23. In case the entity is a finance, investment, chit fund, *nidhi* or mutual benefit company and is dealing or trading in shares, securities, debentures or other investments, the auditor has to state in his report (by virtue of the requirements of the Manufacturing and Other Companies (Auditor's Report) Order, 1988<sup>6</sup>, issued under section 227(4A) of the Companies Act, 1956) whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein as also whether the shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemptions granted under section 49 of the Companies Act, 1956.<sup>7</sup>

### **Immovable Properties**

24. Where immovable properties are held as investments, the auditor should verify them in the same manner as in the case of immovable properties held as fixed assets.<sup>8</sup>

### **Examination of Valuation and Disclosure**

25. The auditor should satisfy himself that the investments have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.<sup>9</sup> Appendix III to this Guidance Note discusses, by way of illustration, the disclosure requirements of some of the Acts. The auditor should also examine whether the method of valuation followed by the entity is consistently applied.

26. The auditor should examine whether, in computing the cost of investments, the expenditure incurred on account of transfer fees, stamp duty, brokerage, etc., is included in the cost of investments.

27. The auditor may ascertain the market value of the quoted securities from official quotations of the stock exchange. In case of unquoted securities, the auditor should ascertain the method adopted by the entity for determining the market value of such securities. He should examine whether the method adopted by the entity is one of the recognised methods of valuation of securities such as break-up value method, capitalisation of yield method, yield to maturity method,

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<sup>6</sup> Currently, the Companies (Auditor's Report) Order, 2003 is in force in terms of section 227(4A) of the Companies Act, 1956.

<sup>7</sup> For a detailed discussion on this aspect, reference may be made to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India.

<sup>8</sup> Reference may be made in this regard to the *Guidance Note on Audit of Fixed Assets*, issued by the Institute of Chartered Accountants of India.

<sup>9</sup> Reference may be made in this regard to Accounting Standard 13, *Accounting for Investments*, issued by the Institute of Chartered Accountants of India.

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etc. In the case of investments other than in the form of securities (e.g., rare paintings), the auditor should examine that the market value has been ascertained on the basis of authentic market reports.

#### **Analytical Review Procedures**

28. As a measure of judging the overall reasonableness of the amounts attributed to investments, the auditor may relate the amount of income received from investments with the corresponding figures of investments and compare this ratio with the similar ratio for the previous years. For this purpose, investments may be classified into appropriate categories. Thus, in the case of fixed interest-bearing securities, the auditor may relate the amount of interest earned with the face value of the related securities. In the case of other securities, the auditor may review the schedule of dividend and other returns and the schedule of investments prepared by the entity and judge their reasonableness.

#### **Management Representations**

29. The auditor should obtain from the management of the entity a written statement regarding classification and valuation of investments for Balance Sheet purposes. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to investments, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding investments is given in Appendix IV to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

#### **Documentation**

30. The auditor should maintain adequate working papers regarding audit of investments. Among others, he should maintain on his audit file, the management representation letter concerning investments.

### ***Appendix I***

#### **Legal Requirements Relating to Investments**

*(Ref. Paragraph 2)*

This Appendix contains an illustrative description of the legal provisions regarding investments as contained in the Companies Act, 1956, Banking Regulation Act, 1949, Insurance Act, 1938, and the Cooperative Societies Act, 1912. It may be emphasised that

this Appendix is only illustrative in nature and is not intended to give an exhaustive description of all the relevant legal requirements applicable to different types of entities. Moreover, the legal requirements may change from time to time and therefore, this Appendix should not be construed as representing the correct legal position at all points of time.

### **Provisions of the Companies Act, 1956**

The main relevant sections are section 49, section 108, section 292, section 293(1)(c) and section 372, besides requirements of inquiry/reporting under sections 227(1A) and 227(4A).

Section 49 provides that, subject to certain exceptions, investments made by a company on its own behalf shall be made and held by it in its own name.

Section 108 lays down the mode of transfer of shares and debentures and prescribes the period of validity of blank transfers. Sections 108A-108I lay down certain restrictions on acquisition and transfer of shares.

Section 292 provides that the power to invest the funds of a company shall be exercised by its Board of Directors on behalf of the company only by means of resolutions passed at meetings of the Board. However, the Board may, by a resolution passed at a meeting, delegate this power to any of its committees, the managing director, the manager or any other principal officer of the company. In such case, every resolution delegating the power to invest the funds of the company shall specify the total amount upto which the funds may be invested and the nature of the investments which may be made, by the committee or the person to whom the power to invest is so delegated.

Section 293(1)(c) provides that the Board of Directors of a public company, or of a private company which is a subsidiary of a public company, shall not invest otherwise than in trust securities, the amount of compensation received by it in respect of the compulsory acquisition of any undertaking or of any premises or properties used for any such undertaking except with the consent of the company in a general meeting.

Section 372 provides that a company, whether by itself or together with its subsidiaries, shall not be entitled to acquire, by way of subscription, purchase or otherwise, the shares of any other body corporate except to the extent and except in accordance with the restrictions and conditions, specified in the section.

### **Provisions of the Banking Regulation Act, 1949**

Section 19 of the Act provides that no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less. The above restriction, however, does not apply to the holding by a banking company of shares in its subsidiary. A banking company is also prohibited from holding shares, whether as pledgee, mortgagee or absolute owner, in any

### **III.42 Auditing Pronouncements**

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company in the management of which, any managing director or manager of the banking company is in any manner concerned or interested.

Section 24 of the Banking Regulation Act provides that every banking company shall maintain in India in cash, gold or unencumbered approved securities, an amount which shall not, at the close of business on any day, be less than twenty-five per cent or such other percentage not exceeding forty, as the Reserve Bank of India may from time to time specify, of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight.

The above provisions also apply to the State Bank of India and its subsidiaries and the nationalised banks.

#### **Provisions of the Insurance Act, 1938**

Section 27(B) of the Insurance Act, 1938 provides that no insurer carrying on general insurance business can invest or keep invested any part of his assets otherwise than in any of the approved investments or in other investments which satisfy certain conditions or in certain prescribed assets which are deemed to be approved investments for the purposes of this section.

A general insurance company can invest any part of its assets in investments other than the investments mentioned above, provided that (i) the total amount of all such investments does not exceed 25 per cent of its assets and (ii) the making or the continuance of the investment is with the consent of all the directors, present and eligible to vote, at a meeting, special notice of which, has been given to all directors, then in India. All such investments including investments in which any director is interested must be reported without delay to the Controller of Insurance with full details of the investments and the extent of any director's interest in any such investment.

An insurer cannot invest or keep invested any part of his assets in the shares of any one banking company or investment company more than (a) ten per cent of his assets, or (b) two per cent of the subscribed share capital and debentures of the banking company or investment company concerned, whichever is less.

Further, an insurer cannot invest or keep invested any part of his assets in the shares or debentures of any one company other than a banking company or investment company more than (a) ten per cent of his assets, or (b) ten per cent of the subscribed share capital and debentures of the company, whichever is less.

Where an investment is in partly paid-up shares, the uncalled liability on such shares shall be added to the amount invested, for the purpose of determining whether such investment exceeds the limits referred to above. However, an insurer can subscribe to the right shares notwithstanding the limits specified above.

These limits do not apply to an investment made by an insurer in the shares of any other insurance company carrying on insurance or re-insurance business in India.

The Controller of Insurance can waive for a specified period and with certain conditions, the limits specified above if, on an application from the insurer, he is satisfied that special grounds exist warranting such waiver.

An insurer cannot invest or keep invested any part of his assets in the shares or debentures of any private company.

### **Provisions of the Cooperative Societies Act, 1912**

Section 32 of the Cooperative Societies Act, 1912 provides that a registered society can invest or deposit its funds only:

- (a) in Government Savings Banks;
- (b) in any of the securities specified in section 20 of the Indian Trusts Act, 1882;
- (c) in the shares or on the security of any other registered society;
- (d) with any bank or person carrying on the business of banking, approved for this purpose by the Registrar; or
- (e) in any other mode permitted by the rules.

## **Appendix II**

### **Illustrative Letter of Confirmation – Investments Held by Banks**

*(Ref. Paragraph 17)*

[Letterhead of entity]

[Date]

..... (Bank)

.....

Dear Sirs,

For audit purpose, kindly send directly to our auditors (name and address of the auditors) a certificate regarding all the shares, debentures and other securities belonging to us but lying with you as (i) security against loans and advances to us, or (ii) in safe custody account at the close of business on .....

For your convenience, we enclose in duplicate a form in which the certificate may be sent. Please send one copy to our auditors, retaining the other for your records. Should you find the space on the form insufficient to contain all the relevant information, please attach a separate statement.

We would request you to state NIL wherever applicable.

Yours faithfully,

**(to be signed by person authorised to operate accounts)**

### Disclosure Requirements Relating to Investments

*(Ref. Paragraph 25)*

To illustrate the manner of disclosure of investments in the financial statements, this Appendix discusses the requirements of the Companies Act, 1956, the Banking Regulation Act, 1949, and the Insurance Act, 1938, insofar as they relate to disclosure of information regarding investments in the financial statements prepared and presented in accordance with the provisions of these statutes. As regards the co-operative societies, the form and content of their financial statements are governed by the rules framed by the State Government concerned. It may be emphasised that, in every case, there should be an adequate disclosure of all relevant information to facilitate proper understanding of the financial statements by the users.

#### Requirements of the Companies Act, 1956

Schedule VI to the Companies Act, 1956 requires the disclosure of investments in the balance sheet as below:

- (1) Investments in Government or Trust Securities.
- (2) Investments in shares, debentures or bonds (showing separately shares fully paid up and partly paid up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies).
- (3) Immovable properties.
- (4) Investments in the capital of partnership firms.

The above particulars have to be given showing the nature of investments and mode of valuation, for example, cost or market value. Further, the aggregate amount of the company's quoted investments and the market value thereof have to be shown. The aggregate amount of the company's unquoted investments is also required to be shown.

A statement of investments (whether shown under "Investments" or under "Current Assets" as stock-in-trade, separately classifying trade investments and other investments) is required to be annexed to the balance sheet, 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 on the balance sheet date or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investments so made in each such body corporate. In the case of an investment company, i.e., a company whose principal business is the acquisition of shares, stocks, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership

firms, the names of the firms (with the names of all their partners, total capital and the share of each partner) are required to be given in the statement.

### **Requirements of the Banking Regulation Act, 1949**

The Third Schedule to the Banking Regulation Act, 1949, requires the investments to be classified under the following heads for the purpose of balance sheet presentation:

- I. Investments in India in
  - (i) Government securities
  - (ii) Other approved Securities
  - (iii) Shares
  - (iv) Debentures and Bonds
  - (v) Subsidiaries and/or joint ventures
  - (vi) Others (to be specified)Total:
  
- II. Investments outside India in
  - (i) Government securities (including local authorities)
  - (ii) Subsidiaries and/or joint ventures abroad
  - (iii) Other investments (to be specified)Total:  
Grand Total: (I &II)

### **Requirements of the Insurance Act, 1938**

The First Schedule to the Insurance Act, 1938 requires the disclosure of investments of an insurer as below:

- Deposit with the Reserve Bank of India (Securities to be specified)
- Indian Government Securities
- State Government Securities
- British, British Colonial and British Dominion Government Securities
- Foreign Government Securities
- Indian Municipal Securities
- British and Colonial Securities
- Foreign Securities
- Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the Indian Government or a State Government
- Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the British or any Colonial Government

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- Bonds, Debentures, stocks and other securities whereon interest is guaranteed by any Foreign Government
- Debentures of any railway in India
- Debentures of any railway out of India
- Preference or guaranteed shares of any railway in India
- Preference or guaranteed shares of any railway out of India
- Railway Ordinary Stocks (i) in India (ii) out of India
- Other Debentures and Debenture stock of companies incorporated (i) in India (ii) out of India
- Other guaranteed and preference stocks and shares of companies incorporated (i) in India (ii) out of India
- Other ordinary stocks and shares of companies incorporated (i) in India (ii) out of India
- Holdings in Subsidiary companies

The book value and the market value have to be shown in respect of the investments. Where the market value is ascertained on a basis other than the published quotations, the manner in which such value has been arrived at, is also required to be disclosed.

## **Appendix IV**

### **Representation Letter for Investments**

*(Ref. Paragraph 29)*

The following is a sample representation letter for investments. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

#### **(Letterhead of Entity)**

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Limited as of ..... 19...., and for the year then ended, we confirm to the best of our knowledge and belief, the following representations concerning investments.

1. The current investments as appearing in the balance sheet consist of only such investments as are by their nature readily realisable and intended to be held for not more than one year from the respective dates on which they were made. All other investments have been shown in the balance sheet as 'long-term investments'.

2. Current investments have been valued at the lower of cost and fair value. Long-term investments have been valued at cost, except that any permanent diminution in their value has been provided for in ascertaining their carrying amount.
3. In respect of offers of right issues received during the year, the rights have been either been subscribed to, or renounced or allowed to lapse. In no case have they been renounced in favour of third parties without consideration which has been properly accounted for in the books of account.
4. All the investments produced to you for physical verification belong to the entity and they do not include any investments held on behalf of any other person.
5. The entity has clear title to all its investments including such investments which are in the process of being registered in the name of the entity or which are not held in the name of the entity. There are no charges against the investments of the entity except those appearing in the records of the entity.

Yours faithfully,

(Signature of responsible official of the entity)

## GUIDANCE NOTE ON AUDIT OF DEBTORS, LOANS AND ADVANCES\*

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*The following is the text of the Guidance Note on Audit of Debtors, Loans and Advances issued by the Auditing Practices Committee (APC)\*\* of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.*

1. Paragraph 2.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Paragraph 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Debtors, Loans and Advances, Chapter-7 of the *Statement on Auditing Practices*, titled 'Debtors, Loans and Advances', shall stand withdrawn. In due course of time, the entire *Statement of Auditing Practices* shall be withdrawn.

### Introduction

3. Debtors, loans and advances may constitute a significant proportion of the total assets of an entity. Debtors represent the amounts due to an entity for goods sold or services rendered or in respect of other similar contractual obligations, but do not include the amounts which are in the nature of loans or advances. Loans represent the claims of an entity in respect of such contractual obligations as moneys lent. Advances represent payments made on account of,

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\* Issued in November, 1994.

\*\* Now known as the Auditing and Assurance Standards Board (AASB).

but before completion of, a contract or before acquisition of goods or receipt of services. For purposes of this Guidance Note, debtors, loans and advances include instruments such as bills of exchange, promissory notes and similar other instruments, evidencing debtors, loans and advances.

4. An important feature of debtors, loans and advances which has a significant effect on the related audit procedures is that these assets are represented only by documentary evidence; they have no physical existence. Moreover, the documentary evidence is generally in the form of invoices, loan documents, etc., prepared by the entity itself. The auditor should take these factors into account in designing his audit procedures.

### **Internal Control Evaluation**

5. The auditor should study and evaluate the system of internal control relating to debtors, loans and advances, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to debtors, loans and advances.<sup>1</sup>

#### ***(a) In respect of debtors***

- (i) The basis on which credit limits for customers are to be determined should be clearly laid down. The credit limits fixed in respect of individual customers should be approved by an official independent of the sales department. These limits should be checked before orders are accepted from the customers. There should also be a system of periodic review of the credit limits.
- (ii) The procedure should ensure prompt recording of debts and realisations and of linking receipts with outstandings.
- (iii) There should be a procedure for preparation of aging schedule of debtors at regular intervals. The schedules should be reviewed by a responsible official and necessary action initiated in respect of overdue accounts.
- (iv) Statements of account should be sent to all debtors at periodic intervals. They should be prepared and despatched by a person independent of the ledger-keeper. The debtors should be requested to confirm the balances as per the statements with reference to their own

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<sup>1</sup> The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976, which contains an illustrative discussion on internal controls in relation to debtors and loans and advances.

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records. The confirmations received should be reviewed by a person independent of the ledger-keeper and the person responsible for preparing the statements of account, and necessary action taken in case of discrepancies.

- (v) All material adjustments in debtors' accounts, particularly those relating to rebates, allowances, commissions etc., should require approval of the competent authority. Similarly, any write-off of bad debts should require approval of the competent authority.
- (vi) There should be a system of periodic reconciliation of various debtor balances with related control accounts.

#### ***(b) In respect of loans and advances***

- (i) As far as possible, the system should specify the following:
  - o total amount up to which loans may be made;
  - o the purposes for which loans may be made;
  - o maximum amount of loans which may be made for each such purpose in individual cases;
  - o the terms on which such loans may be made;
  - o the persons who are authorized to make loans;
  - o procedure for ensuring compliance with relevant legal requirements.
- (ii) All variations in the terms of loans and advances should be duly approved in writing by the competent authority.
- (iii) Where security is taken against the loans, the form and adequacy of security should be reviewed by a responsible official.
- (iv) The loan and security documents should be kept in safe custody of a responsible official. A record of all such documents should be maintained and the documents should be periodically verified with reference to such records.
- (v) The system should provide for identification of cases where principal and/or interest have become overdue or where any other terms are not being complied with.
- (vi) Confirmation of balances should be obtained at periodic intervals in the same manner as in the case of debtors.

## **Verification**

6. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices (SAP) 5, *Audit Evidence*). In carrying out an audit of debtors, loans and advances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

- Existence - that all amounts recorded in respect of debtors, loans and advances are outstanding as at the date of the balance sheet.
- Completeness - that there are no unrecorded debtors, loans and advances.
- Valuation - that the stated basis of valuation of debtors, loans and advances is appropriate and properly applied, and that the recoverability of debtors, loans and advances is recognised in their valuation.
- Disclosure - that the debtors, loans and advances are disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

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

- (a) examination of records;
- (b) direct confirmation procedure (also known as 'circularisation procedure');
- (c) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor.

## **Examination of Records**

7. The auditor should carry out an examination of the relevant records to satisfy himself about the validity, accuracy and recoverability of the debtor balances. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.

8. The auditor should check the agreement of balances as shown in the schedules of debtors with those in the ledger accounts. He should also check the agreement of the total of debtor balances with the related control accounts. Any differences in this regard should be examined.

### **III.52 Auditing Pronouncements**

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9. Verification of subsequent realizations is a widely used procedure, even in cases where direct confirmation procedure is followed. In the case of significant debtors, the auditor should also examine the correspondence or other documentary evidence to satisfy himself about their validity and accuracy.

10. While examining the schedules of debtors with reference to the debtors' ledger accounts, the auditor should pay special attention to the following aspects:

- (a) Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.
- (b) Whether the amounts outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.
- (c) Whether transfers from one account to another are properly evidenced.
- (d) Whether provisions for allowances, discounts and doubtful debts are required. In this regard, the auditor should recognise that even though a debtor may have confirmed the balance due by him, he may still not pay the same.

11. The following are some of the indications of doubtful and uncollectible debts, loans and advances:

- (a) The terms of credit have been repeatedly ignored.
- (b) There is stagnation, or lack of healthy turnover, in the account.
- (c) Payments are being received but the balance is continuously increasing.
- (d) Payments, though being received regularly, are quite small in relation to the total outstanding balance.
- (e) An old bill has been partly paid (or not paid), while later bills have been fully settled.
- (f) The cheques received from the debtor have been repeatedly dishonoured.
- (g) The debt is under litigation, arbitration, or dispute.
- (h) The auditor becomes aware of unwillingness or inability of the debtor to pay the dues e.g., a debtor has either become insolvent, or has closed down his business, or is not traceable.
- (i) Amounts due from employees, which have not been repaid on termination of employment.
- (j) Collection is barred by statute of limitation.

12. Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorisation should be inspected.

13. In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized. If it appears that they are not collectible, they should be shown as doubtful. Similar considerations apply in respect of claims for export incentives, claims for price escalation in case of construction contracts, claims for interest on delayed payments, etc.

14. The auditor should examine whether the contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.<sup>2</sup>

### **Special Considerations in Case of Loans and Advances**

15. In general, the procedure outlined above in regard to debtors is also applicable in the case of loans and advances. However, in the case of loans and advances, the auditor may find greater documentary evidence (in the form of loan and security documents and related correspondence) on which he can place reliance.

16. In the case of loans and advances, an important aspect to be examined by the auditor is whether the entity is empowered to make loans. In many cases, the statute governing the entity may contain restrictions or conditions about the amount of loans, purposes for which loans may be granted, parties to which loans may be granted etc. Similarly, the internal regulations of the entity may also prescribe the procedure to be followed for making the loans. For instance, in the case of companies, sections 292, 295 and 370 place restrictions on the making of loans by companies.<sup>3</sup> The competence of the borrower to receive the loan may also affect the legality and, hence, the recoverability of the loan. The auditor should examine the loan documents and other evidence with reference to the above while determining the legality and recoverability of the loans made by the entity.

17. The auditor should ascertain whether the parties to whom loans and advances have been made have complied with the terms and conditions relating

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<sup>2</sup> Reference may be made in this regard to Accounting Standard (AS) 4, *Contingencies and Events Occurring after the Balance Sheet Date*, issued by the Institute of Chartered Accountants of India.

<sup>3</sup> For a detailed study of this aspect, reference may be made to the Institute's publication titled *A Guide to Company Audit*. Similarly, in the case of entities like banks, insurance companies, etc., reference may be made to the relevant publication(s) of the Institute, e.g., *Guidance Note on Audit of Banks*, *Guidance Note on Audit of Companies Carrying on General Insurance Business*, *Guidance Note on Companies Carrying on Life Insurance Business*, *Guide to Audit of Cooperative Societies*, etc.

### **III.54 Auditing Pronouncements**

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to payment of interest, repayment of loans or adjustment of advances, etc. In the case of defaults, e.g., where the repayment of loans or advances or the payment of interest are overdue, the auditor should consider whether such defaults are indicative of unwillingness or inability of the parties concerned to make the payment.

18. The auditor should pay particular attention to loans and advances given to parties in whom directors or persons who are substantial owners of the entity are interested. He should ascertain the purpose of such loans and advances, the terms and conditions on which they have been made as also their recoverability.

19. The auditor should also examine any other aspects required to be examined or reported upon by the relevant statute. For example, the auditor of a company covered by the Manufacturing and Other Companies (Auditor's Report) Order, 1988, is required to state in his report whether the terms and conditions on which loans and advances have been made are *prima facie* prejudicial to the interests of the company. Similarly, clause (a) of sub-section (1A) of section 227 of the Companies Act, 1956, requires the auditor to inquire "whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members".

#### **Direct Confirmation Procedure**

20. The verification of balances by direct communication with debtors is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. It must be recognised, however, that mere confirmation of balance by a debtor does not by itself ensure ultimate recovery. Moreover, the utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, that it is unlikely that adequate response would be received from the debtors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

21. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain debtors. In such cases, the auditor should consider whether there are valid grounds for such a request. For example, the management may explain the reason as being the fact that there is a dispute with the particular debtor and the request for confirmation may aggravate sensitive negotiations between the entity and the debtor. Before

accepting a refusal as justified, the auditor should examine any available evidence to support the management's explanations, e.g., correspondence between the entity and the debtor. In such a case, alternative procedures should be applied to debtors not subjected to confirmation. In appropriate cases, the auditor may also need to re-consider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.

22. The confirmation date, the method of requesting confirmations, and the particular debtors from whom confirmation of balances is to be obtained are to be determined by the auditor. While determining the information to be obtained, the form of confirmation, as well as the extent and timing of application of the confirmation procedure, the auditor should consider all relevant factors such as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts, the probability that requests will receive consideration, and the materiality of the amounts involved.

23. The debtors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the debtors at a date other than the balance sheet date, he should examine the movements in debtor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that debtor balances stated in the balance sheet are not materially misstated.

24. The form of requesting confirmation from the debtors may be either (a) the 'positive' form of request, wherein the debtor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request, wherein the debtor is requested to respond only if he disagrees with the balance shown.

25. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. An illustrative positive form of request letter is given in Appendix I to this Guidance Note.

26. The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the debtors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as

### **III.56 Auditing Pronouncements**

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to enable the auditor to obtain the same degree of assurance with respect to the debtor balances. An illustrative negative form of request letter is given in Appendix II to this Guidance Note.

27. In many situations, it may be appropriate to use the positive form for debtors with large balances and the negative form for debtors with small balances.

28. Where the number of debtors is small, all of them may be circularized, but if the debtors are numerous, this may be done on a sample basis. The sample list of debtors to be circularized, in order to be meaningful, should be based on a complete list of all debtor accounts. While selecting the debtors to be circularized, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition, the auditor should select accounts in respect of which provisions have been made or balances have been written off during the period under audit or earlier years and request confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with nil balances. The nature of the entity's business (e.g., the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the debtors as a whole.

29. In appropriate cases, the debtor may be sent a copy of his complete ledger account for a specific period as shown in the entity's books. This procedure is more likely to reveal errors and fraud and may be particularly useful in the case of large accounts involving many entries, or where there is evidence that accounts are in dispute or are not being settled in accordance with the entity's usual trade terms.

30. The method of selection of the debtors to be circularised should not be revealed to the entity until the trial balance of the debtors' ledger is handed over to the auditor. A list of debtors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to debtors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

31. Where positive form of request is used, the auditor may, in appropriate cases, request the entity to follow up with a reminder to those debtors from whom he

receives no replies. In exceptional circumstances, the auditor may also correspond directly with those significant debtors from whom he receives no replies despite reminders. In the event of inadequacy of responses received, the auditor will have to increase the extent of examination of records and analytical review procedures beyond that planned originally.

32. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of debtors taken as a whole.

### **Analytical Review Procedures**

33. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to debtors, loans and advances:

- (a) comparison of closing balances of debtors, loans and advances with the corresponding figures for the previous year;
- (b) comparison of the relationship between current year debtor balances and the current year sales with the corresponding figures for the previous year;
- (c) comparison of actual closing balances of debtors, loans and advances with the corresponding budgeted figures, if available;
- (d) comparison of current year's aging schedule with the corresponding figures for the previous year;
- (f) comparison of significant ratios relating to debtors, loans and advances with the similar ratios for other firms in the same industry, if available;
- (g) comparison of significant ratios relating to debtors, loans and advances with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of debtors, loans and advances. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

### **Disclosure**

34. The auditor should satisfy himself that the debtors, loans and advances have been disclosed properly in the financial statements. Where the relevant statute lays

### **III.58 Auditing Pronouncements**

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down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

#### **Management Representations**

35. The auditor should obtain from the management of the entity, a written statement regarding recoverability of debtors and loans and advances and their classification for balance sheet purposes. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to debtors, loans and advances, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding debtors, loans and advances is given in Appendix III to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

#### **Documentation**

36. The auditor should maintain adequate working papers regarding audit of debtors, loans and advances. Among others, he should maintain on his audit file, the confirmations received as well as any undelivered letters of request for confirmation. The management representation letter concerning debtors, loans and advances should also be maintained on the audit file.

### ***Appendix I***

#### **Illustrative Letter of Confirmation to be Sent to Debtors Positive Form**

*[Ref. Paragraph 25]*

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly confirm directly to our auditors (name and address of the auditors) that the balance of `..... due by you as on ....., as shown by our books, is correct. The details of the balance are as under:<sup>4</sup>

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<sup>4</sup> In case the list of invoices forming the balance is too large, these details may not be given.

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<i>Invoice No.</i>	<i>Date</i>	Order Reference or Acceptance or Tender No. etc. (To be used Particularly for Government Customers)	Amount
		Total	_____
		Less : Advance received	_____
		Net Amount due by you (₹)	_____

A stamped envelope addressed to our auditors is enclosed for your convenience.

If the amount shown is in agreement with your books, kindly strike-out the paragraph marked (B) below. If the amount shown is not in agreement with your books, kindly furnish the details in the proforma given in the paragraph marked (B) below and strike-out paragraph (A). In either case, kindly sign at the place provided below and return this entire letter directly to our auditors in the enclosed envelope. Your prompt compliance with this request will be appreciated.

Kindly return this form in its entirety.

Yours Faithfully,

(Signature of responsible official of the entity)

.....

(Do not perforate the form at this point)

(Name and Address of entity)

(A) We confirm that the above stated amount is correct as at \_\_\_\_\_

OR

(B) We state that the above-stated amount is not correct as per our records. The details of the balance as at \_\_\_\_\_ as per our records are as below:

Invoice No.	Date	Order Reference	Amount
		Total	_____
		Less: Advanced paid	_____
		Net Amount due from us (₹)	_____
		Net Amount due from us (₹)	_____

Date

(Signature of debtor/responsible official)

**Appendix II**

**Illustrative Letter of Confirmation to be Sent to Debtors Negative Form**

*[Ref. Paragraph 26]*

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly write directly to our auditors (name and address of the auditors) if the balance of ` due by you as on \_\_\_\_\_ as shown by our books, is not correct, giving details of the differences. The details of the balance are as under:<sup>5</sup>

<i>Invoice No.</i>	<i>Date</i>	<i>Order Reference or Acceptance or Tender No. etc. (To be used particularly for Government Customers)</i>	<i>Amount</i>
		Total	_____
		Less: Advanced paid	_____
		Net Amount due by you (`)	_____

If you do not notify our auditors of any difference within ten days of the date of this letter, it will be presumed that the balance stated above is correct.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

**Appendix II**

**Representation Letter for Debtors, Loans and Advances**

*[Ref. Paragraph 35]*

*The following is a sample representation letter for debtors, loans and advances. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.*

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<sup>5</sup> In case the list of invoices forming the balance is too large, these details may not be given.



## GUIDANCE NOTE ON AUDIT OF CASH BANK BALANCES\*

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*The following is the text of the Guidance Note on Audit of Cash and Bank Balances issued by the Auditing Practices Committee (APC)\*\* of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.*

1. Para 2.1 of the *Preface to the Statements on Standard Auditing Practices*, issued by the Institute of Chartered Accountants of India, states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."
2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Cash and Bank Balances, Chapter 6 of the *Statement on Auditing Practices*, titled 'Cash and Bank Balances', shall stand withdrawn.<sup>1</sup> In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.

### Introduction

3. Cash and bank balances may constitute a significant proportion of the total assets of an entity. An important feature of cash and bank balances which has a significant impact on the related audit procedures is that these assets are highly prone to misappropriation, misapplication and other forms of fraud.

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\* Issued in November, 1994.

\*\* Now known as the Auditing and Assurance Standards Board (AASB).

<sup>1</sup> The special aspects of audit of cash and bank balances in the case of banks are dealt with in the Guidance Note on Audit of Banks (edn. 2001).

4. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices 5, *Audit Evidence*). In carrying out an audit of cash and bank balances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Existence - that recorded cash and bank balances exist as at the year-end.

Rights and obligations - that recorded cash and bank balances represent the assets of the entity.

Completeness - that there are no unrecorded cash and bank balances.

Besides the above, in certain situations, the auditor may also be particularly concerned with the valuation of cash and bank balances, e.g., in the case of foreign currency held by the entity or in the case of bank accounts designated in foreign currencies.

### **Internal Control Evaluation**

5. The auditor should study and evaluate the system of internal control relating to cash and bank balances to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to cash and bank balances.<sup>2</sup>

- (a) segregation of duties relating to authorisation of transactions, handling of cash/issuance of cheques and writing of books of account, and rotation of the duties periodically;
- (b) proper authorisation of cash and banking transactions;
- (c) daily recording of cash transactions;
- (d) safeguards such as restrictive crossing of cheques, use of pre-printed, pre-numbered forms;
- (e) periodic reconciliation of bank balances;
- (f) reconciliation of cash-on-hand with book balance on a daily basis or at other appropriate intervals, including surprise checks by higher authorities;
- (g) safe custody of cash, cheque books, receipt books etc.; and
- (h) cash/fidelity insurance.

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<sup>2</sup> The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the *Internal Control Questionnaire*, issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to cash and bank balances.

## Verification

6. Verification of cash and bank balances may be carried out by employing the procedures described in paragraphs 7-27. It may, however, be emphasised that the nature, timing and extent of substantive procedures to be performed is a matter of professional judgement of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

## Verification of Cash Balances

7. The auditor should carry out physical verification of cash at the date of the balance sheet. However, if this is not feasible, physical verification may be carried out, on a surprise basis, at any time shortly before or after the date of the balance sheet. In the latter case, the auditor should examine whether the cash balance shown in the financial statements reconciles with the results of the physical verification after taking into account the cash receipts and cash payments between the date of the physical verification and the date of the balance sheet. Besides physical verification at or around the date of the balance sheet, the auditor should also carry out surprise verification of cash during the year.

8. All cash balances in the same location should be verified simultaneously. Where petty cash is maintained by one or more officials, the auditor should advise the entity to require the officials concerned to deposit the entire petty cash on hand on the last day with the cashier. The auditor should enquire whether the cashier also handles cash of sister concerns, staff societies, etc. In such a case, cash pertaining to them should also be verified at the same time so as to avoid chances of cash balances of one entity being presented as those of another.

9. If IOUs ('I owe you') or other similar documents are found during physical verification, the auditor should obtain explanations from a senior official of the entity as to the reasons for such IOUs/other similar documents remaining pending. It should also be ensured that such IOUs/other similar documents are not shown as cash-on-hand.

10. The quantum of torn or mutilated currency notes should be examined in the context of the size and nature of business of the entity. The auditor should also examine whether such currency notes are exchanged within a reasonable time.

11. If, during the course of the audit, it comes to the attention of the auditor that the entity is consistently maintaining an unduly large balance of cash- on-hand, he should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balances as shown by the books. If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not

satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

12. Where post dated cheques are on hand on the balance sheet date, the auditor should verify that they have not been accounted for as collections during the period under audit.

### **Verification of Bank Balances**

13. The auditor should advise the entity to send a letter to all its bankers to, directly confirm the balances to the auditor. The Appendix to this Guidance Note gives an illustrative proforma letter of request for confirmation to be used for this purpose. The request for confirmation should also cover dormant accounts as well as accounts closed during the year.

14. The auditor should examine the bank reconciliation statement prepared as on the last day of the year. He may also examine the reconciliation statements as at other dates during the year. It should be examined whether (i) cheques issued by the entity but not presented for payment, and (ii) cheques deposited for collection by the entity but not credited in the bank account, have been duly debited/credited in the subsequent period. For this purpose, the bank statements of the relevant period should be examined. If the cheques issued before the end of the year have not been presented within a reasonable time, it is possible that the entity might have prepared the cheques before the end of the year but not delivered them to the parties concerned. In such a case, the auditor should examine that the entity has reversed the relevant entries.

15. Where the auditor finds that post-dated cheques are issued by the entity, he should verify that any cheques pertaining to the subsequent period have not been accounted for as payments during the period under audit.

16. The auditor should pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment/write-off.

17. The auditor should be alert to the possibility that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

18. Where a large number of cheques has been issued/deposited in the last few days of the year, and a sizeable proportion of such cheques has subsequently

### **III.66 Auditing Pronouncements**

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remained unpaid/uncleared, this may indicate an intention of understating creditors/debtors or understating/overstating bank balances. In such a case, it may be appropriate for the auditor to obtain confirmations from the parties concerned, especially in respect of cheques involving large amounts. The auditor should also examine whether a reversal of the relevant entries would be appropriate under the circumstances.

19. The procedures discussed in paragraph 18 should also be considered by the auditor in cases where a large number of cheques is on hand at the date of the balance sheet and a sizable proportion of such cheques has subsequently remained undeposited / uncleared.

20. In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.

21. In respect of fixed deposits or any other type of deposits with banks, the relevant receipts/certificates, duly supported by bank advices, should be examined.

22. Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

23. The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

24. Where material amounts are held in bank accounts which are blocked, e.g., in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

25. Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

### **Examination of Valuation and Disclosure**

26. The auditor should satisfy himself that cash and bank balances have been valued and disclosed in the financial statements in accordance with recognised

accounting policies and practices and relevant statutory requirements, if any.<sup>3</sup> In this regard, the auditor should examine that following items are not included in cash and bank balances:

- (a) Temporary advances.
- (b) Stale or dishonoured cheques.

Postage and revenue stamps, if material in amount, may be shown separately instead of being included under cash and bank balances.

27. The auditor should also examine that suitable disclosures as mentioned in paragraphs 20 and 24 above are made in relevant cases.

## ***Appendix***

### **Illustrative Letter of Confirmation – Bank Balances**

*(Ref. Paragraph 13)*

[Letterhead of Entity]

[Name and Address of Bank]

[Date]

Dear Sirs,

Please send directly to our auditors ..... (name and address of the auditors) details of balances as at the close of business on [date] ..... of all our accounts with you as well as details of charges held against such balances, with a copy to us. For your convenience, we enclose in duplicate a form in which details of our balances with you can be filled in. If you find the spaces on the form insufficient to contain all the relevant information, please attach a separate statement.

Please note that this request covers all our accounts with you as at the above-mentioned date, including any dormant accounts. We would also request you to give particulars of any of our accounts closed during the year. We would request you to state "Nil", wherever applicable.

Yours faithfully,

(Signature of person authorised to operate accounts)

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<sup>3</sup> For valuation of foreign currency held as cash-in-hand and bank balances designated in foreign currencies, reference may be made to Accounting Standard 11, Accounting for the Effects of Changes in Foreign Exchange Rates, issued by the Institute of Chartered Accountants of India.

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#### Reply from (Bank)

[Name and Address of Auditors]

Dear Sirs,

Date: \_\_\_\_\_

Re : (Name of Client)

At the request of our clients, we submit below particulars of their accounts, Investments, bills, etc., as at the close of business on ..... as shown by our records.

1.	<i>Current Accounts in Credit</i>			
	Designation of Account	Amount		
2.	<i>Overdrawn Current Accounts, Overdraft Accounts or Cash Credit Accounts.</i>			
	Designation of Account	Amount		Security held (give brief description. In the case of securities please list fully)
3.	<i>Loan Accounts</i>			
	Designation of Account	Amount		Security held (give brief description. In the case of securities please list fully)
4.	<i>Fixed, Call and Short Deposit Accounts</i>			
	Amount	Interest Accrued to the closing date	Due Date	Particulars of any charges of liens
5.	<i>Investments and Other Documents of Title Held in Safe Custody</i>			
	Designation.			Face value or number of shares held.
6.	<i>Margin against letters of credit Guarantees issued, etc.</i>			
	Designation of Account	Amount		

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7.	<i>Bills for Collection</i>			
	Designation of Account	Amount	Due date	
8.	<i>Bills Discounted or Purchased.</i>			
	Name of Drawee	Amount	Due date	
9.	<i>Letters of Credit Open and Outstanding</i>			
	In favour of	Amount not utilised	Valid upto	
10.	<i>Guarantees given on behalf of clients</i>			
	In favour of	Amount.	Date of expiry	

We certify that the above particulars are full and correct and do not exclude any other obligations of the entity to us.

Yours faithfully,

Name of Bank  
Designation of Signatory

## GUIDANCE NOTE ON AUDIT OF LIABILITIES\*

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*The following is the text of the Guidance Note on Audit of Liabilities issued by the Auditing Practices Committee (APC)\*\* of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.*

1. Para 2.1 of the *Preface to the Statements on Standard Auditing Practices* issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Liabilities, Chapter 9 of the *Statement on Auditing Practices*, titled 'Liabilities', shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.

### Introduction

3. Liabilities are the financial obligations of an enterprise other than owners' funds.

4. Liabilities include loans and borrowings, trade creditors and other current liabilities, deferred payment credits, instalments payable under hire purchase agreements, and provisions. Besides liabilities, this Guidance Note also deals with contingent liabilities, i.e., obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable.

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\* Issued in November, 1994.

\*\* Now known as the Auditing and Assurance Standards Board (AASB).

5. Special considerations may apply in the case of audit of liabilities of specialised entities like banks, financial institutions and venture capital funds.

6. Liabilities generally constitute a significant proportion of the total sources of funds of an entity. The audit of liabilities is primarily directed at ensuring that all known liabilities have been properly accounted for, since material omission or misstatement of liabilities vitiates the true and fair view of the financial statements.

7. An important feature of liabilities which has a significant effect on the related audit procedures is that these are represented only by documentary evidence which originates mostly from third parties in their dealings with the entity.

8. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions [see Statement on Standard Auditing Practices (SAP) 5, *Audit Evidence*]. In carrying out an audit of liabilities, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to satisfy himself that all known liabilities are recorded and stated at fair and reasonable amounts.

### **Internal Control Evaluation**

9. The auditor should study and evaluate the system of internal control relating to liabilities to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to liabilities.<sup>1</sup>

(a) *In respect of loans and borrowings (including advances and deposits)*

- (i) As far as possible, the following should be clearly specified:
  - o the borrowing powers and limits;
  - o persons authorised and competent to borrow;
  - o terms of borrowings;
  - o procedure for ensuring compliance with relevant legal requirements/ internal regulations.
- (ii) Any variations in the terms of loans and borrowings should be truly approved/ratified in writing by competent authority.
- (iii) Security offered against loans and borrowings should be properly recorded and periodically reviewed.

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<sup>1</sup> The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the Internal Control Questionnaire, issued by the Institute of Chartered Accountants of India, which contains, *inter alia*, an illustrative list of internal controls in relation to creditors and borrowings.

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- (iv) The records and documents should be kept in proper custody and reviewed periodically.
  - (v) The system should bring out all cases of non-compliance with terms and conditions including amounts of principal and/or interest which have become overdue.
  - (vi) Confirmation of balances should be obtained at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.
  - (vii) There should be a proper procedure for year-end valuation of loans and borrowings, especially for those designated in foreign currencies.<sup>2</sup>
- (b) *In respect of Trade Creditors*
- (i) The procedure should ensure proper recording of transactions and facilitate the linking of payments with outstandings.
  - (ii) The payments made to creditors should be in line with the approved policies of the entity.
  - (iii) There should be specific procedures for payments against duplicate invoices or other duplicate records as well as for payments against accounts which have remained unclaimed for quite some time.
  - (iv) There should be a procedure for preparation of schedules of trade creditors at periodic intervals; this should be reviewed by a responsible person and necessary action initiated on overdue accounts.
  - (v) Statements of account should be called for creditors at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.
  - (vi) All adjustments in the creditors' accounts such as those relating to claims for returns, defectives, short receipts of goods, rebates, allowances and commissions etc., should require approval of competent authority. Similarly, any write-back of creditors' balances and escalation claims should be approved by competent authority.
  - (vii) There should be appropriate cut-off procedures in relation to transactions affecting the creditor accounts.
- (c) *In respect of other current liabilities, trade deposits and provisions*

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<sup>2</sup> Reference may be made in this regard to Accounting Standard 11 (revised 2003), *Effects of Changes in Foreign Exchange Rates*, issued by the Institute of Chartered Accountants of India.

The internal control procedures as spelt out above for loans and borrowings and creditors broadly apply in relation to these items.

10. In respect of contingent liabilities, the auditor should examine whether the internal control system of the entity provides for a procedure for identifying and estimating such liabilities and for periodic review of the same.

### **Verification**

11. Verification of liabilities may be carried out by employing the following procedures:

- (a) examination of records;
- (b) direct confirmation procedure;
- (c) examination of disclosure;
- (d) analytical review procedures,
- (e) obtaining management representations.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgement of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

### **Examination of records**

#### **Loans and Borrowings**

12. The auditor should satisfy himself that the loans obtained are within the borrowing powers of the entity.

13. The auditor should carry out an examination of the relevant records to judge the validity and accuracy of the loans.

14. In respect of loans and advances from banks, financial institutions and others, the auditor should examine that the book balances agree with the statements of the lenders. He should also examine the reconciliation statements, if any, prepared by the entity in this regard.

15. The auditor should examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. He should particularly examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with.

16. Where the entity has accepted deposits, the auditor should examine whether the directives issued by the Reserve Bank of India or other appropriate authority are complied with.

### **III.74 Auditing Pronouncements**

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17. In case the value of the security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent of the market value of the security.

18. Where short-term secured loans have been disclosed separately from other secured loans, the auditor should verify the correctness of the amount of such short-term loans.

19. Where instalments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g., in parentheses or by way of a footnote), the auditor should verify the correctness of the amount of such instalments.

20. The auditor should examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts and also examine the security aspect. Future instalments under hire purchase agreements for the purchase of assets may be shown as secured loans.

21. The deferred payment credits should be verified with reference to the important terms in the agreement, including due dates of payments and guarantees furnished by banks. The auditor should also verify the copies of hundies/bills accepted separately.

#### *Trade Creditors and Other Current Liabilities*

22. The auditor should check the adequacy of cut-off procedures adopted by the entity in relation to transactions affecting the creditor accounts. For example, the auditor may examine the documents relating to receipt of goods from suppliers during a few days immediately before the year-end and verify that the related invoices have been recorded as purchases of the current year.

23. The auditor should check that the total of the creditors' balances agrees with the related control account, if any; the difference, if any, should be examined.

24. The auditor should examine the correspondence and other relevant documentary evidence to satisfy himself about the validity, accuracy and completeness of creditors/ acceptances.

25. The auditor should verify that in cases where income is collected in advance for services to be rendered in future, the unearned portion, not applicable to the period under audit, is not recognised as income of the period under audit but is shown in the balance sheet as a part of current liabilities.

26. While examining schedule of creditors and other schedules such as those relating to advance payments, unclaimed dividends and other liabilities, the auditor should pay special attention to the following aspects:

- (a) long outstanding items;
- (b) unadjusted claims for short supplies, poor quality, discount, commission, etc.;
- (c) liabilities not correlated/adjusted against related advances;
- (d) authorisation and correctness of transfers from one account to another.

Based on his examination as aforesaid, the auditor should determine whether any adjustments in accounts are required.

27. In case there are any unusual payments around the year-end, the auditor should examine them thoroughly. In particular, the auditor should examine if the entries relating to any such payments have been reversed in the subsequent period.

28. The auditor should review subsequent transactions to identify/confirm material liabilities outstanding at the balance sheet date.

## **Provisions**

29. The term 'provision' means amounts retained by way of providing for depreciation or diminution in value of assets or retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy. Provisions include those in respect of depreciation or diminution in the value of assets, product warranties, service contracts and guarantees, taxes and levies, gratuity, proposed dividend etc. This Guidance Note, however, does not deal with provisions for depreciation or diminution in the value of assets.

30. The audit of provisions primarily involves examining the reasonableness and adequacy of the amounts provided for. The auditor should also examine that the provisions made are not in excess of what is reasonably required.

31. *Provisions for Taxes and Duties:* The adequacy of the provision for taxation for the year should be examined. The position regarding the overall outstanding liability of the entity as at the date of balance sheet should be reviewed. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. Similarly, he should examine whether excess provisions or refunds have been properly adjusted. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether any short provisions have been made good.

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If there is a material tax liability for which no provision is made in the accounts, the auditor should qualify his report in this respect even if the reserves are adequate to cover the liability.

32. If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under section 246 of the Income-tax Act, 1961. Where an application for rectification of mistake (e.g., under section 154 of the Income tax Act, 1961) has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date* issued by the Institute of Chartered Accountants of India). In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

33. In case the entity has made the provision for taxation on the basis of the tax-effect accounting method, the auditor should examine whether the method has been applied properly.<sup>3</sup>

34. *Provision for Gratuity*: The auditor should examine whether the entity is required to pay gratuity to its employees by virtue of the provisions of the Payment of Gratuity Act, 1972 and/or in terms of agreement with employees and, if so, whether provision for accruing gratuity liability has been made by the entity.<sup>4</sup> The auditor should examine the adequacy of the gratuity provision with reference to the actuarial certificate obtained by the entity. In case the entity has not obtained such an actuarial certificate, the auditor should examine whether the method followed by it for calculating the accruing liability for gratuity is rational.

35. *Provision for Bonus*: In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor

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<sup>3</sup> Reference may be made in this regard to the Accounting Standard (AS) 22, *Accounting for Taxes on Income* issued by the Institute of Chartered Accountants of India.

<sup>4</sup> Reference may be made in this regard to Accounting Standard (AS) 15, *Accounting for Retirement Benefits in the Financial Statements of Employers*, issued by the Institute of Chartered Accountants of India.

should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

36. *Provision for Dividends*: The auditor should examine that dividends are provided for as per applicable provisions of the relevant laws and rules framed thereunder, relevant agreements and resolutions.

37. *Other Provisions*: Where provisions are made for liabilities that may arise on account of product warranties, service contracts, performance warranties etc., the auditor should examine whether the provisions made are in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, issued by the Institute of Chartered Accountants of India. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements.

### **Contingent Liabilities**

38. The term 'contingent liabilities' refers to obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. Contingent liabilities may or may not crystallize into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any legal obligation differentiates a contingent liability from a liability that has crystallized. Contingent liabilities should also be distinguished from those contingencies which are likely to result in a loss (i.e., a loss is not merely possible but probable) and which, therefore, require an adjustment of relevant assets or liabilities.<sup>5</sup> Some of the instances giving rise to contingent liabilities are:

- (a) law suits, disputes and claims against the entity not acknowledged as debts:
- (b) membership of a company limited by guarantee.

39. The following general procedures may be useful in verifying contingent liabilities.

- (a) Review of minutes of the meetings of board of directors, committees of board of directors/other similar body.
- (b) Review of contracts, agreements and arrangements.
- (c) Review of list of pending legal cases, correspondence relating to taxes, duties, etc.

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<sup>5</sup> Reference may be made in this regard to the Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date*, issued by the Institute of Chartered Accountants of India.

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- (d) Review of terms and conditions of grants and subsidies availed under various schemes.
- (e) Review of records relating to contingent liabilities maintained by the entity.
- (f) Enquiry of, and discussions with, the management and senior officials of the entity.
- (g) Representations from the management.

40. The auditor should verify that contingent liabilities do not include any items which require an adjustment of relevant assets or liabilities.

#### **Direct Confirmation Procedure**

41. The verification of balances by direct communication with creditors is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. However, the utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, that it is unlikely that adequate response would be received from the creditors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

42. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain creditors. In such cases, the auditor should consider whether there are valid grounds for such a request. For example, the management may explain the reason as being the fact that there is a dispute with the particular creditor and the request for confirmation may aggravate sensitive negotiations between the entity and the creditor. Before accepting a refusal as justified, the auditor should examine any available evidence to support the management's explanations, e.g., correspondence between the entity and the creditor. In such a case, alternative procedures should be applied to creditors not subjected to confirmation. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations,

43. The confirmation date, the method of requesting confirmations, and the particular creditors from whom confirmation of balances is to be obtained are to be determined by the auditor. While determining the information to be obtained, the form of confirmation, as well as the extent and timing of application of the confirmation procedure, the auditor should consider all relevant factors such as the

effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts, the probability that requests will receive consideration, and the materiality of the amounts involved.

44. The creditors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity. Where the auditor decides to seek confirmation from the creditors at a date other than the balance sheet date, he should examine the movements in creditor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that creditor balances stated in the balance sheet are not materially misstated.

45. The form of requesting confirmation from the creditors may be either (a) the 'positive' form of request, wherein the creditor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request, wherein the creditor is requested to respond only if he disagrees with the balance shown.

46. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. An illustrative positive form of request letter is given in Appendix I to this Guidance Note.

47. The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the creditors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same: degree of assurance with respect to the creditor balances. An illustrative negative form of request letter is given in Appendix II to this Guidance Note.

48. In many situations, it may be appropriate to use the positive form for creditors with large balances and the negative form for creditors with small balances.

49. Where the number of creditors is small, all of them may be circularised, but if the creditors are numerous, this may be done on a sample basis. The sample list of creditors to be circularised, in order to be meaningful, should be based on a complete list of all creditor accounts. While selecting the creditors to be circularised, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and supplier accounts with debit balances. In addition, the

### **III.80 Auditing Pronouncements**

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auditor should select accounts in respect of which balances have been written back to the profit and loss account. In such cases, the auditor may decide that the balance as per the books of the entity may not be stated in the request letter sent to the creditors concerned; instead, the creditors may be asked to intimate the balance as per their records. The auditor may also consider including in his sample some of the accounts which have been fully squared up. The nature of the entity's business and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the creditors as a whole.

50. In appropriate cases, the creditor may be sent a copy of his complete ledger account for a specific period as shown in the entity's books. This procedure is more likely to reveal errors and fraud and may be particularly useful in the case of large accounts involving many entries, or where there is evidence that accounts are in dispute or are not being settled in accordance with the usual trade terms.

51. The method of selection of the creditors to be circularised should not be revealed to the entity until the trial balance of the creditors' ledger is handed over to the auditor. A list of creditors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to creditors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

52. Where positive form of request is used, the auditor may, in appropriate cases, request the entity to follow up with a reminder to those creditors from whom he receives no replies. In exceptional circumstances, the auditor may also correspond directly with those significant creditors from whom he receives no replies despite reminders, with intimation to the entity. In the event of inadequacy of responses received, the auditor will have to increase the extent of examination of records and analytical review procedures beyond that planned originally.

53. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of creditors taken as a whole.

## **Examination of Disclosure**

54. The auditor should satisfy himself that the liabilities have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

55. In some cases loans are guaranteed by third parties in whose favour the assets of the entity are charged. The auditor should examine whether the disclosures concerning such loans are appropriate, e.g., they may be classified as secured with disclosure of the fact that the assets of the entity have been charged in favour of third parties which, in turn, have given guarantees to parties from whom loans have been obtained.

56. The auditor should recommend to the entity to disclose, in parentheses or in footnotes, the instalments of term loans, if any, falling due for repayment within the next twelve months.

57. The auditor should examine that the following have been disclosed in respect of contingent liabilities:

- (a) nature of each contingent liability;
- (b) the uncertainties which may affect the future outcome;
- (c) an estimate of the financial effect or a statement that such estimate cannot be made.

## **Analytical Review Procedures**

58. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions:

- (a) comparison of closing balances of loans and borrowings, creditors, etc., with the corresponding figures for the previous year;
- (b) comparison of the relationship between current year creditor balances and the current year purchases with the corresponding figures for the previous year;
- (c) comparison of actual closing balances of loans and borrowings, creditors, etc., with the corresponding budgeted figures, if available;
- (d) comparison of current year's aging schedule of creditors with the corresponding figures for the previous year;
- (e) comparison of significant ratios relating to loans and borrowings, creditors, etc., with the similar ratios for other firms in the same industry, if available;

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- (f) comparison of significant ratios relating to loans and borrowings, creditors, etc. with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of liabilities. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor

#### *Special Considerations in the Case of a Company*

59. In addition to the procedures described above, the auditor should also employ the following procedures in the case of audit of a company.

- (a) In determining whether the loans obtained by the company are within its powers, the auditor should scrutinise its memorandum and articles of association and also examine whether the provisions of sections 292 and 293(1(d) of the Companies Act, 1956 are complied with.
- (b) The auditor should examine the register of charges to ensure that charges created have been duly registered. He should also ensure that the description of such charges disclosed in the balance sheet agrees in substance with that stated in the documents creating the charges.
- (c) The auditor should examine all loans taken from bodies corporate under the same management or from a company, firm or other party in which any director is interested and determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are *prime facie* prejudicial to the interest of the company.<sup>6</sup>
- (d) Where the company has accepted deposits, the auditor should examine compliance with the relevant legal provisions, e.g., section 58A of the Companies Act, 1956 and the rules framed thereunder/directions issued by the Reserve Bank of India.
- (e) In respect of unclaimed dividends, the auditor should examine whether the company has complied with the provisions of section 205A of the Companies Act, 1956 and the rules framed there under regarding transfer of certain unpaid or unclaimed dividends to a special bank account/general revenue account of the Central Government.
- (f) The auditor should examine whether any undisputed amounts payable in respect of income-tax, wealth tax, sales tax, customs duty and excise duty are outstanding as at the balance sheet date for a period of more than six months from the date they became payable. If so, the auditor should report the amounts of such outstanding dues.<sup>7</sup>

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<sup>6</sup> Reference may also be made in this regard to the *Statement on the Companies (Auditor's Report) Order, 2003* issued by the Institute of Chartered Accountants of India.

<sup>7</sup> Reference may also be made in this regard to the *Statement on the Companies (Auditor's Report) Order, 2003* issued by the Institute of Chartered Accountants of India.

- (g) The verification procedure to be adopted by the auditor for audit of debentures would vary from year to year, depending upon whether fresh debentures are issued and/or they are redeemed or converted into shares during the year. In case of fresh issue of debentures, the auditor should examine the memorandum and articles of association of the company and resolutions authorising the issue. He should also examine compliance with the requirements of the terms of issue and any variations thereof and necessary approvals/clearances for the issue from authorities concerned such as SEBI, RBI etc. The auditor should also examine that proper accounts are maintained with regard to amounts received towards application, allotment and calls and that the Payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where debentures are issued at a premium/discount, the auditor should ensure that such sums are accounted for distinctly. In case of buy-back, conversion, re-issue or redemption of debentures, the auditor should examine that these are in accordance with the terms of the issue. The auditor should examine that the requirements relating to creation of debenture redemption reserve and, where applicable, sinking fund and its Investment; and other related requirements are complied with.

### **Management Representations**

60. The auditor should obtain from the management of the entity a written statement that all known liabilities have been recorded in the books and that all contingent liabilities have been properly disclosed. While such a representation letter serves as a formal acknowledgment of the management's responsibilities for proper accounting and disclosure of the relevant items, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial statement. A sample management representation letter regarding liabilities and contingent liabilities is given in Appendix III to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

### **Documentation**

61. The auditor should maintain adequate working papers regarding audit of liabilities and contingent liabilities. Among others, he should maintain on his audit file, confirmations received as well as any undelivered letters of request for confirmation. The management representation letter contingent liabilities and contingent liabilities should also be maintained on the audit file.

## **GUIDANCE NOTE ON AUDIT OF REVENUE\***

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*The following is the text of the Guidance Note on Audit of Revenue issued by the Auditing Practices Committee (APC)\*\* of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.*

1. Para 2.1 of the 'Preface to the Statements on Standard Auditing Practices', issued by the Institute of Chartered Accountants of India, states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Revenue, paragraph 11.1 of Chapter 11 of the Statement on Auditing Practices, titled 'Profit and Loss Account', shall stand withdrawn. In due course of time, the entire Statement of Auditing Practices shall be withdrawn.

### **Introduction**

3. Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an entity from the sale of goods, from the rendering of services, and from the use by others of entity resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. The term 'revenue' covers only the gross inflow of cash, receivables or other consideration, as aforesaid, received or receivable by the entity on its own account. Amounts collected on behalf of third parties are

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\* Issued in November, 1994.

\*\* Now known as the Auditing and Assurance Standards Board (AASB).

excluded from revenue. For example, in an agency relationship, revenue from the view point of the agent is the amount of commission receivable by him and not the gross amount of cash, receivables or other consideration collected by him on behalf of the principal.

4. This Guidance Note deals with the audit of the following types of revenue (dealt with in Accounting Standard (AS) 9, *Revenue Recognition*, issued by the Institute of Chartered Accountants of India) arising in the course of the ordinary activities of an entity:

- Sale of goods.
- Rendering of services.
- Use by others of entity resources yielding interest, royalties and dividends.

5. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices (SAP) 5, *Audit Evidence*). In carrying out an audit of revenue, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

- |                             |   |
|-----------------------------|---|
| Occurrence                  | – that recorded revenue arose from transactions which took place during the relevant period and pertain to the entity.  |
| Completeness                | – that there is no unrecorded revenue.  |
| Measurement                 | – that revenue is recorded in the proper amounts and is allocated to the proper period.   |
| Presentation and Disclosure | – that revenue is disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any. |

## **Internal Control Evaluation**

6. The auditor should study and evaluate the system of internal control relating to revenue, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to revenue:<sup>1</sup>

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<sup>1</sup> The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire" issued by the Institute of Chartered Accountants of India in 1976, which contains an illustrative list of internal controls in relation to sales.

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- (a) The systems and procedures relating to generation of revenue including authority to fix prices, offer discounts and other terms of sale.
- (b) Accounting procedures relating to recognition of revenue.
- (c) Existence of periodic reports on actual performance vis-à-vis budgets.

#### **Verification**

7. Verification of revenue may be carried out by employing the following procedures:

- (a) examination of records;
- (a) analytical review procedures.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

#### **Examination of Records**

8. The auditor should examine whether the basis of recognition of revenue by the entity is in accordance with the recognised accounting principles as laid down in Accounting Standard (AS) 9, *Revenue Recognition*, issued by the Institute of Chartered Accountants of India.

9. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to sales and sale returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the despatch documents (such as railway receipts) pertaining to a few days immediately before the year-end and verify that the related sale invoices have been recorded as sales of the current year.

10. The auditor should examine selected entries in the sales journal with reference to the related sale invoices, dispatch documents and other supporting documents such as the customers' orders, credit approval notes, etc. He should compare the actual price charged with the authorised price lists or with the authorisation by the appropriate official of the entity, as the case may be. The auditor should also trace the selected entries to the customers' account.

11. The auditor should also examine selected despatch documents with reference to related sale invoices and the sales journal.

12. The auditor should examine selected entries in the sales return journal with reference to the receiving reports in respect of goods returned, credit notes and entries in the customers' accounts. Similarly, the auditor should examine selected credit notes with reference to entries in the sales return journal, receiving reports in respect of goods returned, and entries in the customers' accounts.

13. In respect of goods sent on approval, the auditor should particularly examine that revenue in respect of such goods is not recognised until (a) the goods have been formally accepted by the buyer, or (b) the buyer has done an act adopting the transaction, or (c) the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

14. In respect of sales to intermediate parties (i.e., where goods are sold to distributors, dealers or others for resale), the auditor should examine that revenue from such sales is not recognised until the significant risks and rewards of ownership have passed. However, in situations where an intermediate party is in substance an agent (e.g., a consignee), revenue should not be recognised until the related goods are sold to a third party.<sup>2</sup>

15. Where the consideration is receivable in installments and includes an element of interest, the auditor should examine that the revenue attributable to the sale excludes the interest element.

16. In respect of export sales, the auditor should carry out the following procedures in addition to the usual audit procedures applicable in respect of domestic sales.

(a) The auditor should examine that revenue from export sales in which consideration is receivable in a foreign currency is recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates<sup>3</sup>.

(b) The auditor should obtain a written representation from the management to the effect that the entity has complied with the legal and regulatory requirements relating to exports.<sup>4</sup>

17. In respect of revenue arising from services rendered (i.e., in the form of fees, commission, brokerage, etc.), the auditor should examine the related agreements and other documents. Similarly, in respect of revenue in the form of interest,

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<sup>2</sup> Reference may be made to AS 1, *Disclosure of Accounting Policies*, for discussion on the concept of "substance over form".

<sup>3</sup> This Accounting Standard has been revised in 2003. The title of the revised Accounting Standard is "Effects of Changes in Foreign Exchange Rates".

<sup>4</sup> Reference may be made in this regard to AAS 11 (**SA 580**), *Representations by Management*.

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dividends and royalties, the auditor should examine the related documents such as loan documents, lease agreements, etc. The auditor may also seek confirmatory certificates from the parties concerned.

18. The auditor should also verify realisations subsequent to the date of the balance sheet to identify items of unrecorded revenue.

#### **Examination of Presentation and Disclosure**

19. The auditor should satisfy himself that the revenue has been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

#### **Analytical Procedures**

20. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to revenue:

- (a) Comparison, product-wise and location-wise, of revenue for the current year with the corresponding figures for previous years.
- (b) Comparison of ratio of gross margin to sales for the current year with the corresponding figures for previous years.
- (c) Comparison of ratio of sales returns to sales for the current year with the corresponding figures for previous years.
- (d) Comparison of ratio of trade discount to sales for the current year with the corresponding figures for previous years.
- (e) Comparison of ratio of excise duty/sales tax/export incentives to sales for the current year with the corresponding figures for previous years.
- (f) Comparison, product-wise and location-wise, of quantity sold during the year with the corresponding figures for previous years.
- (g) Product-wise reconciliation of quantity sold during the year with opening stock, purchases/production and closing stock.
- (h) Comparison of dividend/interest/royalty for the current year with the corresponding figures for previous years.
- (i) Comparison of ratio of income on investments to average investments for the current year (separately for each major type of investment) with the corresponding figures for previous years.

Apart from the above, the auditor may also work out quantitative ratios and reconciliations, e.g., he may relate the quantum of output to the quantum of input to judge its reasonableness. Similarly, he may relate the wage payments to the quantum of output, and so on.

It may be clarified that the foregoing is only an illustrative list of analytical procedures, which an auditor may employ in carrying out an audit of revenue. The exact nature of analytical procedures to be applied in a specific situation is a matter of professional judgment of the auditor.

### **Special Considerations in the Case of a Company**

21. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. For example, as required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988, issued under section 227(4A) of the Act, the auditor should examine whether the transactions of sale of goods, materials and services and purchase of goods and materials, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Act, and exceeding the limits specified in the Order, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials or services or the prices at which transactions for similar goods or services have been made with other parties.<sup>5</sup>

### **Documentation**

22. The auditor should maintain adequate working papers regarding audit of revenue.

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<sup>5</sup> Reference may be made in this regard to Statement on the Manufacturing and Other Companies (Auditor's Report) Order, 1988.

## GUIDANCE NOTE ON AUDIT OF EXPENSES\*

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*The following is the text of the Guidance Note on "Audit of Expenses" issued by the Auditing Practices Committee of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.*

### Introduction

1. An expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period. The expression "cost" means the amount of expenditure incurred on or attributable to a specified article, product or activity.

2. Expenses are recognised by the following approaches:

*(a) Identification with revenue transactions*

Costs directly associated with the revenue recognised during the relevant period are considered as expenses and are charged to income for the period.

*(b) Identification with a period of time*

In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time.<sup>1</sup> Such costs are regarded as 'period costs' and are expensed in the relevant period, e.g, salaries, telephone, travelling, depreciation on office building, normal interest, etc. Similarly, the costs, the benefits of which, do not clearly extend beyond the accounting period are also charged as expenses.

3. The following features of expenses affect the nature, timing and extent of the related audit procedures:

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\* Published in November, 2001 issue of 'The Chartered Accountant'.

<sup>1</sup> Reference may be made in this regard to Guidance Note on Accrual Basis of Accounting.

- (a) In the case of most items of expenses, documentary evidence originating from third parties is available.
- (b) The nature and relative significance of various items of expenses usually differ from one enterprise to another, depending primarily on the nature of operations carried out by them. For example, in the case of most manufacturing enterprises, the principal items of expenses would include the cost of raw materials consumed, labour cost and other conversion costs. On the other hand, in the case of a trading enterprise, the principal items of expenses would generally be the cost of goods sold. In the case of an enterprise supplying, providing, maintaining and operating any services, the principal items of expense would include personnel and professional expenses, office maintenance, etc.
- (c) The amount of some expenses has a logical relationship with certain other financial statement items while the amount of some other expenses does not have such a relationship. For example, in an enterprise where the production process is standardised, the consumption of raw materials (and, therefore, the cost of raw materials consumed) has a logical relationship with the quantum of output. Similarly, the proportion of various constituents of cost of production is expected to remain more or less constant in the absence of known conditions to the contrary. Likewise, proportion of the amount of interest for a period to the amount of loans outstanding during the period is expected to vary within certain specific limits. On the other hand, the expenditure on research and development often has little relationship with other items in the financial statements.
- (d) The amount of some items of expenses (e.g., gratuity, taxes, bonus, etc.) is significantly affected by applicable laws.

4. In an audit, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see *SAP 5, Audit Evidence*). In carrying out an audit of expenses, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Occurrence	that recorded expenses arose from transactions or events which took place during the relevant period and pertain to the entity.
Completeness	that there are no unrecorded expenses.

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Measurement	that expenses are recorded in the proper amounts and are allocated to the proper period.
Presentation and Disclosure	that expenses are disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

5. In view of the divergence in the nature of expenses incurred by different enterprises, it is not possible to describe the audit procedures applicable in carrying out an audit of expenses in all situations. This Guidance Note provides guidance on procedures to be employed in carrying out an audit of expenses which would be applicable in the case of most enterprises. It is recognised, however, that audit procedures different from or additional to those described in this Guidance Note may be necessary in a particular case, depending upon its specific facts and circumstances.

#### Internal Control Evaluation

6. The auditor should study and evaluate the system of internal control relating to expenses, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to expenses:<sup>2</sup>

- (a) The systems and procedures relating to incurring of expenses including authorisation procedures.
- (b) Accounting procedures relating to recognition of expenses.
- (c) Existence of periodic reports on actual performance *vis a vis* budgets and internal management reports, if any.

#### Verification

7. Verification of expenses may be carried out by employing the procedures, *viz.*, (a) examination of records; and (b) analytical procedures. The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's

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<sup>2</sup> The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to petty cash, cash and bank payments, salaries and wages and purchases.

evaluation of the effectiveness of the related internal controls. The auditor should examine whether the basis of recognition of expenses by the entity is in accordance with the recognised accounting principles.

*(a) Examination of Records*

8. Examination of records and documents is one of the most important techniques of auditing. An auditor has to examine a large number of documents in the course of an audit since most transactions are supported only by documentary evidence. The accounting systems of business enterprises are so designed that documentary evidence is created in respect of each transaction. The auditor should carry out an examination of the relevant records to satisfy himself about the validity, accuracy and other assertions with regard to various expenses incurred by the entity. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.

*(b) Analytical Procedures*

9. The auditor should conduct analytical procedures which involve analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.<sup>3</sup>

10. The following paragraphs describe the audit procedures applicable in respect of various items of expenses.

### **Goods and Raw Materials Consumed**

11. The auditor's examination of the cost of goods, stores and materials consumed during the year would involve, *inter alia*, examination of purchases of goods and materials made during the year as well as of purchase returns and of opening and closing inventories.

### **Purchases and Purchase Returns**

12. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to purchases and purchase returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the selected receipt documents (such as goods received notes) pertaining to a few days immediately before the year-end and verify that the related purchase invoices have been recorded as purchases of the current year. The auditor should

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<sup>3</sup> Refer to Auditing and Assurance Standard (AAS) 14 (SA 520), *Analytical Procedures*.

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pay particular attention to the cut-off procedures relating to purchases, both indigenous and imported, to determine whether these procedures ensure recognition of purchases at the time the significant risks and rewards of ownership of the related goods pass on to the entity.

13. The auditor should examine selected entries in the purchase journal with reference to the related purchase invoices, receipt records and other supporting documents such as the purchase orders. The auditor should also trace the selected entries to the suppliers' account.

14. While examining purchase invoices, the auditor should examine whether subsidies, rebates, duty drawbacks or other similar items have been properly accounted for. As per AS 2, costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

15. The auditor should also examine selected receipt records with reference to related purchase invoices and the purchase journal.

16. The auditor should examine selected entries of purchase returns with reference to the goods returned notes, debit notes and entries in the suppliers' accounts. Similarly, the auditor should examine selected debit notes with reference to purchase returns, goods returned notes, and entries in the suppliers' accounts.

17. In case of transactions between related parties, the auditor should pay special attention to nature and description of such transactions.<sup>4</sup>

18. The auditor should obtain a representation from the management to the effect that the entity has complied with the legal and regulatory requirements, if any. When the auditor becomes aware of non-compliance, the auditor should obtain sufficient information to evaluate the possible effect in the financial statements. The auditor should also consider communication/reporting of non-compliance with the management including audit committee, users of financial statements and to regulatory authorities, as may be appropriate.<sup>5</sup>

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<sup>4</sup> Refer to Accounting Standard (AS) 18, *Related Party Disclosures*.

<sup>5</sup> Refer to Auditing and Assurance Standard (AAS) 21 (**SA 250**), *Consideration of Laws and Regulations in an Audit of Financial Statements*.

19. In respect of imports, the auditor should carry out the following procedures in addition to the usual audit procedures applicable in respect of domestic purchases.

- (a) Besides examining the usual documents relating to purchases, the auditor should also examine such documents as bill of lading, custom documents, etc., which are specific to import transactions.
- (b) The auditor should pay special attention to the terms of import relating to the incidence of charges like insurance and freight, i.e., whether the imports are on C.I.F. basis, or F.O.B. basis, or some other basis.
- (c) The auditor should examine that imports for which consideration is payable in a foreign currency are recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*.

20. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to purchases.

- (a) Comparison, item-wise and location-wise, both quantity and value, of purchases for the current year/period with the corresponding figures for previous years/periods.
- (b) Comparison of ratio of gross margin to sales for the current year/period with the corresponding figures for previous years/periods.
- (c) Comparison of ratio of purchase returns to purchases for the current year/period with the corresponding figures for previous years/periods.
- (d) Product-wise reconciliation of quantity sold during the year/period with opening stock, purchases/production and closing stock.

Apart from the above, the auditor may also work out quantitative ratios and reconciliations, e.g., he may relate the quantum of output to the quantum of input to judge its reasonableness. In case segment information is available, the above procedures may be carried out for each segment.

21. The auditor should also verify payments subsequent to the date of the balance sheet to identify any purchases which have not been recorded in the books of account.

## **Wages and Salaries**

22. The auditor should examine the entries in the payroll/wage sheets with reference to relevant records, e.g., employee's records maintained by the personnel

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department showing details of pay such as basic pay, allowances, annual increments, leaves availed, etc. Special attention may also be paid by auditor in respect of new employees joining the entity during the year. Similarly, the payroll may also be examined with reference to the time records/ attendance records and leave records maintained by the personnel department. The deductions made in respect of income-tax, provident fund, Employees' State Insurance (ESI), welfare schemes, health schemes, etc., may be examined with reference to the returns submitted to the authorities concerned and the receipts/acknowledgments issued by such authorities.

23. The auditor should examine whether any legal, regulatory or contractual requirements having a bearing on the rate or amount of wages and salaries have been complied with. Similar considerations would also apply to payments made to a contractor for hire of labour. Such requirements would include, *inter alia*, the provisions of the Minimum Wages Act, 1948, agreement with the employees, award of competent authority and judicial rulings.

24. In the case of senior management officials, the auditor should pay particular attention to determining whether the salaries payable are as per the terms of contract with the employees concerned. Special requirements of terms of contract such as granting stock options (as per schemes formulated by SEBI), availing leave encashment, total amount payable annually including ex-gratia, etc., should be specifically looked into.

25. In the case of casual labour, besides carrying out the other audit procedures, the auditor should specifically examine the sanction of the competent authority for employment of such labour and ascertain whether such employees are retained as per the time rate or piece-rate basis. In appropriate cases, the auditor may pay a surprise visit to the sites where the casual labour is employed to assess the correctness of the attendance records maintained in respect of such labour. In cases where complete outsourcing of labour has been given to an outside agency, the terms of agreement and compliance thereof would be examined.

26. The auditor should obtain a list of employees who have retired or otherwise left the services of the entity during the period under audit and examine that they have not been included in the payroll.

27. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to wages and salaries:

- (a) comparison of wage bill for the year/period with the wage bill of previous years/periods;

- (b) comparison of the monthly wages and salaries of a month with other months during the year/period and with the corresponding month of the previous years/periods;
- (c) comparison of the wage bill for each department/unit for the current year/period with the corresponding figures for previous years/periods;
- (d) comparison of the ratios of wages and salaries to sales for the current year/period with the corresponding figures for the previous years/periods;
- (e) comparison of the ratio of wages and salaries to cost of production for the current year/period with the corresponding figures for previous years/periods;
- (f) comparison of the ratio of contribution towards provident fund to wages and salaries for the current year/period with the corresponding figures for previous years/periods;
- (g) comparison of the ratio of contribution towards provident fund to wages and salaries for the current year/period with the rate(s) of contribution specified under the law governing provident fund;
- (h) comparison of the ratio of contribution towards ESI to wages and salaries for the current year/period with the corresponding figure for previous years/periods;
- (i) comparison of the ratio of contribution towards ESI to wages and salaries for the current year/period with the rate(s) of contribution specified under the law governing the ESI.

### **Bonus**

28. In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965, and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

### **Retirement Benefits**

29. The auditor should examine whether the entity is liable to pay any retirement benefits to its employees such as provident fund, superannuation/pension, gratuity, etc., whether in pursuance of requirements of any law and/or in terms of

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agreement with the employees<sup>6</sup>. If so, the auditor should examine whether the amount payable has been computed in accordance with the relevant legal and/or contractual requirements. In respect of gratuity/pension, the auditor should specifically examine whether the provision for accruing gratuity/pension liability has been made by the entity. The auditor should examine the adequacy of provision with reference to the actuarial certificate obtained by the entity<sup>7</sup>. In case the entity has not obtained such an actuarial certificate, the auditor should examine that the method followed by it, say, group gratuity insurance scheme taken by the entity, for calculating the accrued liability for gratuity is rational.

#### **Other Conversion Costs**

30. The auditor should verify the other conversion costs (such as power and fuel, processing charges, etc.) with reference to the supporting documents and related agreements. In case the material is sent outside to third parties for processing, necessary charges including existence of materials, wastage, etc., need to be ascertained and accounted for. In addition, the auditor may also compare the amount of expense on a particular item with the corresponding figure for previous years. Similarly, he may work out the ratios of different items of conversion costs to total cost of production for the current year and compare the same with the corresponding figures for previous years.

#### **Establishment and General Administrative Expenses**

31. The auditor should verify establishment expenses and general administrative expenses such as insurance, rent, rates, conveyance, travelling, telephone, entertainment, printing and stationery, general expenses, etc., with reference to the sanction of the competent authority, the supporting documents, related agreements and the rules and regulations followed by the entity. The auditor may also compare the amounts of these expenses with the corresponding figures for previous years. Similarly, he may work out the ratios of different items of expenses to sales for the current year and compare the same with the corresponding figures for previous years.

#### **Interest and Financial charges**

32. The auditor should verify the amount of interest expense for the year with reference to the terms and conditions of relevant agreements. The auditor may also

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<sup>6</sup> Attention is invited in this regard to Accounting Standard (AS) 15, *Accounting for Retirement Benefits in the Financial Statements of Employers*.

<sup>7</sup> Attention is also invited in this regard to Auditing and Assurance Standard (AAS) 9 (**SA 620**), *Using the Work of an Expert*.

work out the ratio of interest expense for the year to average interest-bearing loans and advances outstanding during the year and compare it with the corresponding figure for previous years and reconcile the same. The auditor should particularly examine that interest as well as other financing costs such as commitment fees on funds borrowed for a qualifying asset included in the gross book value of the asset to which they relate and have not been charged to the Profit and Loss Account of the period in which they are incurred.<sup>8</sup> If the entity has paid any penal interest, it should also be examined. Such interest should be disclosed as part of normal interest. The auditor should consider, having regard to the materiality, whether it requires separate disclosure.

### **Depreciation**

33. The auditor should check the calculation of depreciation. The total depreciation arrived at should be compared with that of previous years to identify reasons for variations. The auditor should particularly examine whether the depreciation charge having regard to rate of depreciation and method of depreciation followed consistently is adequate keeping in view the generally accepted bases of accounting for depreciation<sup>9</sup>. Alternatively, the auditor may consider qualifying his report. In case, assets have been revalued by entity during the year, the auditor should ensure that the depreciation has been computed properly.

### **Research and Development Expenses**

34. The auditor should verify various items of expenses incurred on research and development with reference to supporting documents and related agreements. For example, the cost of materials consumed for research and development may be verified with reference to such documents as purchase invoices, goods received notes, records relating to issue of materials, etc. The auditor should particularly examine whether the accounting policy followed by the entity regarding treatment of research and development costs is in accordance with Accounting Standard (AS) 8, *Accounting for Research and Development*.

35. The auditor should examine whether the deferral meets the appropriate legal requirements, if any. If an accounting policy for deferral of research and developments is adopted, it should be applied to all such projects which meet the criteria laid down for deferral under AS 8. The auditor should examine whether the criteria laid down in AS 8 which previously justified the deferral of certain

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<sup>8</sup> Attention is invited Accounting Standard (AS) 16, *Borrowing Costs*.

<sup>9</sup> Attention is also drawn to Accounting Standard (AS) 6, *Depreciation Accounting*.

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research and development costs no longer apply, the unamortised balance has been charged as an expense of the year. Similarly, the auditor should examine that where the criteria for deferral continue to be met but the amount of unamortised balance of the deferred research and development costs and other relevant costs exceed the expected future revenues/benefits related thereto, such excess has been charged as an expense immediately.

#### **Repairs and Maintenance**

36. The auditor should scrutinise the repairs and maintenance account to ascertain that new fixed assets and substantial improvements to existing assets have not been included in repairs and maintenance. The auditor should exercise special care particularly in case large amounts charged to the Profit and Loss Account.

#### **Contingencies**

37. In respect of product warranties, service contracts, performance warranties, etc., the auditor should examine whether provisions have been made in accordance with Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date*. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements and the assessment based on his past experience.

#### **Taxes on Income**

38. The auditor should examine that tax expense or tax saving has been properly computed and disclosed in the financial statements<sup>10</sup>. The tax expense for the period which comprises current tax and deferred tax is to be included in the determination of net profit or loss for the period under audit. In case of companies attracting minimum alternate tax, it has to be ensured that proper provision has been considered in the accounts. The auditor should examine that the deferred taxes have been recognised for all timing differences subject to consideration of prudence in respect of deferred tax assets as set out in Accounting Standard (AS) 22, *Accounting for Taxes on Income*. If there is a material departure from the provisions of AS 22, the auditor should qualify his report.

39. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. The relevant orders

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<sup>10</sup> Attention is drawn to Accounting Standard (AS) 22, *Accounting for Taxes on Income*.

received up to the time of audit should be considered and, on this basis, it should be examined whether adjustment is required in the financial statements.

40. If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under relevant provisions of the Income-tax Act, 1961. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard 4, *Contingencies and Events Occurring After the Balance Sheet Date*). In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

41. The auditor should obtain from the management, a statement showing the status of pending tax matters. He should examine the statements to assess the adequacy of provisions made in respect of those matters in the context of their current status.

### **Special Considerations in the Case of a Company**

42. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. Some of the illustrative procedures specifically applicable in the case of audit of a company are described below. It may be clarified that the following is not an exhaustive list of additional procedures to be carried out in the case of audit of expenses in the case of a company.

- (a) The auditor should examine whether the managerial remuneration paid or payable by the company is within the limits laid down under section 198 and Schedule XIII to the Companies Act, 1956. The auditor should also examine whether the remuneration paid or payable to the directors of the company, including any managing or whole-time director, has been determined by the Articles of Association of the company or by a resolution of the company passed in a general meeting. The auditor should also examine whether the remuneration of directors complies with the provisions of section 309 of the Companies Act, 1956. The auditor should further examine whether the

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computation of net profit for purposes of managerial remuneration is in accordance with sections 349 and 350 of the Companies Act, 1956.

- (b) The auditor should examine whether the contributions, if any, made by the company to charitable and other funds not directly relating to the business of the company or the welfare of its employees comply with the provisions of section 293 of the Companies Act, 1956. According to this section, the board of directors of a public company cannot, except with the consent of the company in general meeting, contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed Rs.50,000 or 5 per cent of the average net profits of the company as determined in accordance with the provisions of section 349 and section 350 during the three financial years immediately preceding, whichever is greater. The auditor should examine whether the Memorandum of Association of the company empowers it to make contributions to charitable or other funds not directly relating to the business of the company or the welfare of its employees. If the objects clause in the Memorandum does not contain such authority, the company has no power to make such contributions.

The auditor should ask the management to prepare a schedule of contributions to various funds covered by section 293 made during the year, giving the names of the institutions to which contributions have been made, the amounts paid and the dates on which the contributions were approved by the board of directors. He should also ask the management to prepare a computation showing the limits of permissible contributions which can be made under this section.

- (c) The auditor should examine whether political contributions made by the company are within the limit prescribed in section 293A of the Companies Act, 1956.<sup>11</sup> Where the limit laid down under section 293A is adhered to and the facts are properly disclosed, the auditor has no further duty. Where, however, the facts regarding such contributions are not properly disclosed, the auditor should qualify his report and state the facts therein. Where the auditor has genuine doubt regarding the applicability of the Section, he should ensure that the fact is properly disclosed in his audit report.

Where the auditor is satisfied that political contributions have been made in excess of the limit prescribed in section 293A, he should bring this to the

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<sup>11</sup> Reference may be made in this regard to the Guidance Note on Section 293A of the Companies Act, 1956 and the Auditor.

attention of the shareholders by qualifying his audit report and making a mention of the excess amount involved, if ascertainable.

The auditor should obtain a certificate from company's board of directors to the effect that all amounts of contributions to political parties or for any political purpose to any person falling under the provisions of section 293A have been brought into the books of account of the company and that no amounts of such nature other than those so included in the books have been paid/given, directly or indirectly.

- (d) The auditor should examine whether the contribution, if any, to the National Defence Fund or any other fund approved by the Central Government for the purpose of national defence complies with the provisions of section 293B of the Companies Act, 1956. This section empowers the board of directors to make such contributions. It may be noted that unlike the contributions to charitable or other funds not directly relating to the business of the company or to the welfare of its employees, contributions to National Defence Fund (or other similar funds) can be made by a company even where the Memorandum of Association of the company does not specifically empower it in this regard. The auditor should examine whether the total amount or amounts contributed by the company to the National Defence Fund (or other similar funds) during the year have been suitably disclosed in the profit and loss account.
- (e) In respect of payments to sole-selling agents, the auditor should examine whether the provisions of sections 294, 294A and 294AA have been complied with.
- (f) The auditor should examine whether the provisions of section 297 have been complied with in appropriate cases. He should also examine compliance with the terms and conditions, if any, stipulated by the Central Government in its approval under the proviso to sub-section (1) of section 297.
- (g) In case any partner or relative of a director of the company, any firm in which such director, or relative of such director, is a partner, any private company of which such director is a director or member, or any director, or manager of such a private company, holds any office or place of profit under the company or under any subsidiary of the company, the auditor should examine whether the provisions of section 314 have been complied with.

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- (h) The auditor should examine whether any personal expenses have been charged to revenue account.<sup>12</sup>
- (i) The auditor should examine whether the transaction of purchase of goods and materials and services, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Companies Act, 1956, as aggregating during the year to Rs.50,000\* (Rupees Fifty Thousand) or more in respect of each party, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials and services or the prices at which transaction for similar goods or service have been made with other parties.<sup>13</sup>
- (j) The auditor should examine whether any undisputed amounts payable in respect of income tax, wealth tax, sales tax, customs duty and excise duty were outstanding as at the last day of financial year concerned, for a period of more than six months from the date they became payable have been reported under MAOCARO, 1988<sup>14</sup>.

### Examination of Presentation and Disclosure

43. The auditor should satisfy himself that the expenses have been properly classified and disclosed in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

### Management Representation

44. The auditor should consider obtaining a management representation on expenses charged to the statement of profit or loss when other sufficient appropriate audit evidence cannot reasonably be expected to exist.<sup>15</sup>

### Documentation

45. The auditor should maintain adequate working papers regarding audit of expenses.<sup>16</sup>

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<sup>12</sup> Reference may be made in this regard to the Statement on the Qualification in Auditor's Report.

<sup>13</sup> This limit has been enhanced to Rs. five lacs by the Companies (Auditor's) Report Order, 2003.

<sup>14</sup> Reference may be made in this regard to the Statement on the Companies (Auditor's Report) Order, 2003.

<sup>15</sup> Replaced by the Companies (Auditor's Report) Order, 2003.

<sup>16</sup> Reference may be made in this regard to Auditing and Assurance Standard (AAS-11) **(SA 580)**, *Representation by Management*.

## GUIDANCE NOTE ON SECTION 227 (3)(e) AND (f) OF THE COMPANIES ACT, 1956

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### INTRODUCTION

1. Section 227 of the Companies Act, 1956 (hereinafter referred to as the "Act") deals with the powers and duties of the auditors of companies. Section 227(1A) of the Act requires the auditor to make certain specific enquiries during the course of audit. Section 227(2) of the Act requires the auditor, *inter alia*, to give his report to the members of company on the accounts examined by him, and on every balance sheet and profit and loss account and every document declared to be a part of or annexed to such balance sheet or profit and loss account which are laid before the company in a general meeting during the tenure of the auditor's office. Sub-section (3) of section 227 of the Act also lays down certain matters necessarily required to be reported upon by the auditor in his report. The auditor is also required to include a statement on the matters specified in the Companies (Auditor's Report) Order, 2003 (Revised 2005) (hereinafter referred to as "CARO, 2003"), issued under section 227(4A) of the Act. Sub-section (3) of section 227 of Act provides as follows:

"(3) The auditor's report shall also state -

- (a) whether he has obtained all the information and explanations, which to the best of his knowledge and belief, were necessary for the purposes of his audit;
- (b) whether, in his opinion, proper books of account, as required by law, have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (bb) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by clause (c) of sub-section (3) of that section and how he has dealt with the same in preparing the auditor's report;

### **III.106 Auditing Pronouncements**

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- (c) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns;
  - (d) whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211;
  - (e) in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company;
  - (f) whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274;
  - (g) whether the cess payable under section 441A has been paid and if not, the details of the amount of cess not paid.<sup>1</sup>
2. In terms of reporting requirements under sub-sections (2) and (3) of section 227 of the Act, matters on which the auditor has to report upon, can be broadly divided into two categories as under:
- (i) statements of fact; and
  - (ii) opinions.
3. The statements of fact are:
- (i) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;
  - (ii) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditors has been forwarded to him as required by section 228(3)(c) and how he has dealt with the same in preparing the auditor's report;
  - (iii) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns;
  - (iv) whether any director is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274; and
  - (v) whether the cess payable under section 441A has been paid and if not, the details of the amount of cess not paid.
4. The opinions which the auditor is required to express are:
- (i) whether proper books of account as required by law have been kept by the

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<sup>1</sup> Inserted by the Companies (Second Amendment) Act, 2002.

## **Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 III.107**

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company so far as it appears from the examination of the books and proper returns adequate for the purposes of the audit have been received from branches not visited by him;

- (ii) whether the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211;
- (iii) whether the accounts give the information required by the Act in the manner so required; and
- (iv) whether the accounts give a true and fair view, in the case of the balance sheet of the state of the company's affairs, and in the case of the profit and loss account, of the profit or loss for the year.

### **SCOPE OF THE GUIDANCE NOTE**

5. This Guidance Note is intended to assist the auditors in discharging their duties in respect of clauses (e) and (f) of sub-section (3) of section 227 of the Act. Clause (e) of the said sub-section creates a requirement for the auditor to consider whether any matter leading to the modification of the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company. It may be noted that the matters that lead to modification in the auditor's report on financial statements are an emphasis of matter paragraph, qualification, situation giving rise to limitation on scope and disagreement with the management<sup>2</sup>. If the matter leading to the modification of the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company, the auditor is required to highlight such matter in **thick** type or in *italics*. Under clause (f) of sub-section (3) of section 227 of the Act, the auditor is required to state whether any director of the company is disqualified from being appointed a director of a company in terms of clause (g) of sub-section (1) of section 274 of the Act.

### **REPORTING UNDER SECTION 227(3)(E) OF THE ACT**

6. The relevant extracts of section 227(3)(e) of the Act are reproduced below:

*"3. The auditor's report shall also state –*

.....

*(e) in thick type or in italics, the observations or comments of the auditors, which have any adverse effect on the functioning of the company".*

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<sup>2</sup> Reference may be made to paragraphs 31 through 47 of Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements."

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7. Clause (e) requires the auditor to highlight "in thick type or in italics, the observations or comments which have any adverse effect on the functioning of the company". An auditor's report may contain matters leading to modifications in the auditor's report on financial statements. Such matters may be related to issues which may have an adverse effect on the functioning of the company. The words "observations" or "comments" as appearing in clause (e) of section 227(3) are construed to have the same meaning as referring to "emphasis of matter paragraphs, qualifications, situations giving rise to limitation on scope, disagreements with the management leading to modification in the auditors report". Therefore, only such "observations" or "comments" which have an adverse effect on the functioning of the company are required to be stated in thick type or in italics. For the sake of clarity, it may be noted that neither the auditor's observations nor the comments made by him have any adverse effect on the functioning of a company. Instead, these observations or comments made by the auditor might contain matters which might have an adverse effect on the functioning of a company.

8. The Act does not specify the meaning of the phrase 'adverse effect on the functioning of the company'. The expression may be interpreted to mean that any event affecting the functioning of the company, observed by the auditor, should be reported upon even though it does not affect the financial statements, e.g., revocation of a license to manufacture one out of the many products during the year to which the financial statements relate, etc. However, such an interpretation would not only be beyond the scope of the audit of financial statements of the company but would also not be in accordance with the objective and concept of audit stipulated under the Act. A more logical and harmonious interpretation is that the amendment does not intend to change the basic objective and the concept of audit of financial statements of a company, which is to examine the financial statements with a view to express an opinion thereon.

9. The scope of the audit and auditor's role remains as contemplated under the Engagement Standards and other relevant pronouncements issued by the Institute of Chartered Accountants of India as well as laid down in the Act, i.e., to lend credibility to the financial statements by reporting whether they reflect a true and fair view. SA 200A, "Objective and Scope of the Audit of Financial Statements" specifies, "the auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise". It also states, "the

## **Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 III.109**

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auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements. Furthermore, much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. Because of these factors, absolute certainty in auditing is rarely attainable". Further, it also clarifies that "in forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The auditor recognises that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered. While in many situations the discovery of a material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery".

10. There is no change in the objective and scope of an audit of financial statements because of inclusion of clause (e) in sub-section (3) of section 227 of the Act. The auditor expresses his opinion on the true and fair view presented by the financial statements through his report which may be modified in certain circumstances. However, the auditor would now have to evaluate subject matters leading to modification of the audit report to make judgement as to which of them has an adverse effect on the functioning of the company within the overall context of audit of financial statements of the company. Only such matters, which in the opinion of the auditor, deal with matters that have an adverse effect on the functioning of the company should be given in **thick** type or in *italics*. Conversely, such qualifications or adverse remarks of the auditor, which do not deal with matters that have adverse effect on the functioning of the company, need not be given in **thick** type or in *italics*. Examples of qualifications or adverse comments which have an adverse effect on the functioning of the company include a situation where the going concern assumption is considered inappropriate or there exists any item having a significant impact on the current financial results of the company and which might also have a material effect on the future results of the entity, e.g., non-determination of obsolete stocks / bad debts, significant impairment of the assets, etc.

11. As far as inquiries under section 227(1A) are concerned, the auditor is not required to report on these matters unless he has any special comments to make on any of the items referred to therein. The auditor may also consider

### III.110 Auditing Pronouncements

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highlighting such comments in **thick** type or in *italics* which have any adverse effect on the functioning of the company. Another issue which arises is whether any observation or comment made by the auditor in respect of his statements on matters specified in CARO, 2003 issued under section 227(4A) of the Act, which has any adverse effect on the functioning of the company, should also be reported in terms of this clause. In this regard, it is noted that section 227(4A) of the Act treats the comments on the matters specified in CARO, 2003 as a part of the auditor's report. Accordingly, any observation or comment made by the auditor in his report under CARO, 2003 contain such matters, which, in his opinion, will have any adverse effect on the functioning of the company, should also be reported in **thick** type or *italics* as required by this clause. An example in this regard may be where an auditor in respect of paragraph 4(i)(c) of CARO, 2003 reports that there exists a substantial doubt that without the replacement of significant part of fixed assets sold during the year, the company would be able to continue as a going concern for the foreseeable future.

#### Reporting under Section 227(3)(f) of the Act

12. Clause (f) of section 227(3) of the Companies Act, 1956, is reproduced below:

*"227(3) The auditor's report shall also state –*

.....  
.....

*(f) whether any director is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274."*

13. In order to report upon clause (f) of sub-section (3) of section 227 of the Act, it is essential that the auditor understands the requirements of clause (g) of sub-section (1) of section 274 of the Act. The relevant extracts of section 274(1)(g) referred to in clause (f) of section 227(3), are reproduced below:

*"274(1) A person shall not be capable of being appointed director of a company, if—*

.....  
.....

*(g) such person is already a director of a public company which –*

*(A) has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after the first day of April, 1999; or*

*(B) has failed to repay its deposit or interest thereon on due date or redeem*

## **Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 III.111**

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*its debentures on due date or pay dividend and such failure continues for one year or more;*

*Provided that such person shall not be eligible to be appointed as a director of any other public company for a period of five years from the date on which such public company in which he is a director failed to file annual accounts and annual returns under sub-clause (a) or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend referred to in clause (B)."*

14. On a perusal of section 227(3)(f), it is apparent that the auditor of a company, public or private, has to report on whether any of the directors of the company is disqualified from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act. This is because while clause (f) of section 227(3) is the operating clause, clause (g) of sub-section (1) of section 274 is the defining clause. Thus, in order to be able to make a statement pursuant to clause (f) of sub-section (3) of section 227 of the Act in his report, the auditor would need to satisfy himself as to whether any of the directors of the company is disqualified under section 274(1)(g) from being appointed as a director in a company. It may also be noted that where none of the directors of a private company have been directors in a public company, the disqualification mentioned under section 274(1)(g) would not get attracted since the disqualification under the said section is defined in respect of a person who is director of a public company.

15. Disqualification of a director for being appointed as a director of a company under section 274(1)(g) should be determined with reference to a particular date only. This is so because a director can become disqualified under the said section at any point of time during the year. Further, a director can attract the disqualification if any of the defaults mentioned under section 274(1)(g) is either done by the company being audited (if the company being audited is a public company) or any other public company in which a director of the company being audited is a director or has been a director in a public company which incurred the defaults and the period of five years has not elapsed. These factors make it impracticable for an auditor to determine whether any of the directors of the company attracted the disqualification under section 274(1)(g) at any point of time during the period covered by the auditor's report. It is, therefore, practicable that whether any of the directors of the company has attracted disqualification should be considered as on a particular date, namely, at the balance sheet date.

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16. The Department of Company Affairs<sup>3</sup> ("the Department") vide its Notification numbered GSR 830(E) dated October 21, 2003, has issued "The Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003 (hereinafter referred to as the "Rules") to carry out the purpose of clause (g) of sub-section (1) of section 274 of the Act. The text of the Rules is reproduced in **Appendix I** to this Guidance Note.

17. The Rules are applicable to all public limited companies. However, the question regarding the applicability of the Rules to a company, which has been granted license under section 25 of the Act, and a private company, which is a subsidiary of a body corporate incorporated outside India, is required to be examined.

18. Section 25 of the Act only contains conditions subject to which the Central Government may dispense with the requirement to use the word "limited" or "private limited" in the name of a company. Thus, a public company, which is granted a license under section 25 of the Act, continues to be a public limited company under the Act and therefore the Rules would be applicable to such a public limited company.

19. As far as a private company, which is a subsidiary of a body corporate incorporated outside India is concerned, it may be noted that section 4(7) of the Act provides that:

*"(7)A private company, being a subsidiary of a body corporate incorporated outside India, which, if incorporated in India, would be a public company within the meaning of this Act, shall be deemed for the purposes of this Act to be a subsidiary of a public company if the entire share capital in that private company is not held by that body corporate whether alone or together with one or more other bodies corporate incorporated outside India."*

20. By virtue of section 3(iv)(c), a private company, if it is a subsidiary of a body corporate incorporated outside India, which if incorporated in India would have been a public company and some part of its share capital is held by a legal entity in India, would become a public company within the meaning of the Act. Therefore, the Rules would also be applicable to such a private company.

#### **DISQUALIFICATION UNDER SECTION 274(1)(G)**

21. The situation for disqualification of a director, as envisaged in sub-clause (A)

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<sup>3</sup> Now "Ministry of Company Affairs".

## **Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 III.113**

of clause (g) of section 274 (1) of the Act is that the concerned public company has not filed the annual accounts and annual returns for any continuous three financial years commencing on or after the first day of April 1999. Further, sub-rule (a) of Rule 3 lays down that in such a case, persons who are directors on the last due date for filing the annual accounts and the annual returns shall be disqualified from being appointed as a director of another public company. In this context, it is also necessary to understand as to what is the "last due date" as envisaged by the Rules. The last due date would mean the due date with reference to the annual accounts and annual returns of the last of the three consecutive financial years for which the annual accounts and annual returns have not been filed. The proviso to clause (g) of sub-section (1) of section 274 provides that the period of five years would be reckoned from the date as specified in sub-clause (A), on which the public company failed to file its annual accounts and annual returns. From the above, it is clear that if the following conditions are satisfied in respect of a person, he would become disqualified under sub-clause (A) of clause (g) of sub-section (1) of section 274 of the Act:

- (a) The person is a director in a public company as on the last due date for filing the annual accounts and annual return for three continuous financial years. Thus, even if the person concerned has been appointed as a director in the public company only a few days before the last due date, the person would attract disqualification under section 274(1)(g). Further, a person who ceased to be a director of the public company as on the last due date for filing the annual accounts and annual return for three continuous financial years would not be disqualified from being appointed as a director of a public company.
- (b) The public company has not filed the annual accounts and annual return for three consecutive financial years. Thus, if the said failure is not for a period of three continuous financial years, the disqualification would not be attracted.
- (c) The public company has failed to file both, the annual accounts and annual return. Thus, if the company has filed either the annual accounts or annual return within the due dates, the disqualification would not be attracted.
- (d) The period of five years has not elapsed since the date of default made by the public company. Thus, if the period of five years has elapsed since the date of the default, the person concerned shall not remain disqualified under sub-clause (A) of section 274(1)(g).

22. The situation for disqualification of a director, as envisaged in sub-clause (B) of clause (g) of section 274 of the Act is that the concerned public company has failed to repay its deposit or interest thereon on due date or redeem its

### **III.114 Auditing Pronouncements**

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debentures on due date or pay dividend and such failure continues for a period of one year or more. Further, sub-rule (b) of Rule 3 provides that if a company has failed to repay any deposit, irrespective of the enactment, rules or regulations under which the deposits have been accepted by the companies, or interest thereon, or redeem its debentures, or pay any dividend declared on the respective due dates, and if such failure continues for one year, as described in sub-clause (B) of clause (g) of sub-section (1) of section 274, then the directors of that company would stand disqualified immediately on expiry of one year from the respective due dates. The proviso to the Rule further provides that that all the directors who have been directors in the relevant year, from the due date to the expiry of one year after the due date, will also be disqualified. It may also be noted that that the disqualification on account of the reasons cited under sub-rule (b) of Rule 3 of the Rules is also applicable to the reappointment as a director.

23. The explanation to Rule 3, however, clarifies that a company would not be considered as having defaulted in payment of the dividend referred to in sub-clause (B) of clause (g) of section 274(1) in the following situations:

- (i) The dividend in question has not been claimed; or
- (ii) The dividend in question has been transferred to a separate bank account, i.e., the Unpaid Dividend Account of the company in accordance with the requirements of section 205A of the Act; or
- (iii) The dividend in question has been paid into the Investor Education and Protection Fund as required under section 205C of the Act.

24. The Department has also issued certain Circulars/Notifications in respect of operation/applicability of clause (g) of section 274(1) of the Act. A gist of these Notifications/Circulars is as under:

- (i) In respect of sub clause (B) of clause (g) of section 274(1) of the Act, the Department, vide its general circular numbered 5 of 2003 (F No. 2/5/2001-CLV) dated 14-1-2003 has clarified that default in repayment of privately placed bonds/ debentures/ debt instruments by public financial institutions will not be considered as default to disqualify directors under section 274(1)(g) of the Act.
- (ii) The Department has, vide its notification numbered GSR 829(E), also clarified that the provisions of clause (g) of sub section (1) of section 274 of the Act shall not be applicable to a Government company.
- (iii) Further, the Department has also clarified, vide its general circular numbered

## **Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 III.115**

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8/2002, dated 22-3-2002, that the nominee directors appointed by the public financial institutions and companies established under the Act of Parliament having non obstante provisions over the Companies Act, 1956 like IDBI, LIC, UTI, IIBI, etc., in their respective statutes shall not be liable to be disqualified under section 274(1)(g) of the Act. The Department has also clarified that the nominee directors appointed on the boards of assisted concerns or other public companies by (a) public financial institutions within the meaning of section 4A of the Act; (b) Central or State Government; and (c) banking companies are also exempt from the provisions of section 274(1)(g) of the Act.

25. The proviso to sub-section (1) of section 252 of the Act requires that a public company having a paid-up capital of rupees five crores or more; or one thousand or more small shareholders may have a director elected by such small shareholders in the manner as may be prescribed. The Department had, vide its Notification No. GSR. 168(E), dated March 9, 2001, issued the "Companies (Appointment of the Small Shareholders' Director) Rules, 2001. The said Rules define "small shareholders" as "a shareholder holding shares of nominal value of twenty thousand rupees or less in a public company to which section 252 of the Act applies. The said Rules deal with the manner of election of small shareholders' director, disqualification of such directors and vacation of office by such directors. Rule 5 of the said Rules which deals with the disqualification of small shareholders' directors lists out certain conditions wherein a person shall not be capable of being appointed as a small shareholders' director of a company. The said Rule 5, however, does envisage the situations outlined in clause (g) of section 274(1) as a condition for disqualification. Thus, a logical interpretation of the situation would be that a person appointed as a small shareholders' director pursuant to the above mentioned Rules would not be subject to any disqualification arising in terms of clause (g) of section 274(1) of the Act.

26. The Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003 (the "Rules") have also introduced the concepts of "Disqualifying" and "Appointing" companies. As per Rule 2, a "disqualifying" company is "the company in which the default has occurred on account of which a director stands disqualified". Further, Rule 2 also defines an "appointing" company as "the company in which an individual is seeking an appointment as a director, including reappointment as a director". However, this distinction between the "appointing company" and "disqualifying company" apparently has no significance to the auditor since he is required to state in his report on the financial statements of the company whether any of the directors of the company

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as on the balance sheet is disqualified from being appointed as a director of a company under section 274(1)(g) of the Act.

27. Under Rule 9, every director in a public company registered under the Companies Act, 1956, is required to file Form DD-A, as prescribed in the Rules, before he is appointed or reappointed in any company. Rule 5 also casts a duty on every company which has failed to file its annual accounts and returns and/or fails to repay any deposit, interest, dividend, or fails to redeem its debentures, as described in clauses (A) and (B) of clause (g) of sub-section (1) of section 274 of the Act, to immediately file a return in duplicate in Form DD-B (prescribed in the said Rules) with the Registrar of Companies.

28. Another point to note is that the provisions of clause (g) of section 274(1) of the Act do not find a place in the provisions of section 283 of the Act, which deals with vacation of office by the director(s). Therefore, a director should not be construed as having vacated his office merely because of his having incurred a disqualification under clause (g) of section 274(1) of the Act. Another question that arises in this regard is whether in case all the directors of a company are disqualified under section 274(1)(g), whether such directors can approve the financial statements of the company. As mentioned, in case a director of a company becomes disqualified from being appointed as a director in a company in terms of section 274(1)(g) of the Act, he continues to be a director of the company until the expiry of his term. Therefore, even in a case where all the directors become disqualified from being appointed as a director in a company they can approve the financial statements and continue to discharge the duties and responsibilities assigned by the Act.

#### **DUTIES OF THE AUDITOR UNDER THE RULES**

29. Rule 4 of the Rules deals with the duties of the statutory auditors of both the disqualifying as well as the appointing companies. Sub-rule (a) of Rule 4 requires that the statutory auditors of both the appointing as well as the disqualifying company to:

- (i) report under section 227(3)(f) of the Act to the members of the respective companies as to whether any director is disqualified from being appointed as a director under clause (g) of section 274(1) of the Companies Act, 1956; and
- (ii) furnish a certificate every year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified as a director or not.

30. It is, therefore, clear that the statutory auditors of both the disqualifying as

## **Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 III.117**

well as the appointing company would, in addition to their report in terms of section 227(3)(f) of the Act, would also have to, each financial year, furnish a certificate as required in Rule 4.

31. Sub Rule (b) of Rule 4 further casts a duty on the statutory auditors of the "disqualifying" company to report to the members of the company as required under section 227(3)(f) whether any director in the company has been disqualified during the year from being reappointed as director, or being appointed as a director in another company under clause (g) of section 274(1).

### **Auditor's Procedures for Compliance with Section 227(3)(f) and the Rules**

32. In order to comply with the requirements of section 227(3)(f) of the Act and the Rules, the auditor should obtain a written representation as to:

- (a) Names of directors of the company during the period covered by the auditor's report (including the directors at the balance sheet date), showing separately, the names of nominee directors and directors appointed in accordance with the Companies (Appointment of the Small Shareholders' Director) Rules, 2001
- (b) Particulars of appointment/reappointment, resignation/retirement etc., of each of the above directors.
- (c) Whether in case of directors appointed on or after the date of the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003 coming into effect, each such director has submitted Form DD-A, as required under the said Rules.
- (d) That the information contained in the register of directors maintained under section 303(1) is updated to show the position as on the balance sheet date.
- (e) Whether the company has committed any default as envisaged in sub-clauses (A) and/or (B) of clause (g) of section 274 (1) of the Act.
- (f) In case the company has committed a default under sub-clauses (A) and/ or (B) of clause (g) of section 274(1) of the Act, whether the company has furnished the Form DD-B, as required by the Rules.

33. The auditor should also obtain a written representation from the directors of the company as to whether they have attracted the disqualification in terms of clause (g) of sub-section (1) of section 274 of the Act. The auditor should require the directors to submit a written representation in respect of each public company in which they are directors as to whether as on the balance sheet date the public companies of which he is a director have defaulted in terms of the

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section 274(1)(g). There is a practice amongst many companies that the directors obtain a legal compliance report, periodically, to ensure that the companies have complied with all the legal requirements. Such compliance reports generally also contain the information regarding filing of annual accounts and annual return and compliance with clause (g) of sub-section (1) of section 274 can be a part of the said legal compliance report. Such a compliance report can, therefore, be submitted by the director as an evidence in this regard. In addition to written representation obtained from the director in respect of public companies of which he is a director, the auditor should also obtain written representation from the director in respect of each of those public companies in which he was a director in the past as to whether or not the director is disqualified to be appointed as a director in terms of proviso to Section 274(1)(g). The auditor should insist that written representations provided by the management as well as the directors appointed prior to the issuance of Rules or the legal compliance report, as the case may be, should be taken on record by the Board of Directors of the company being audited. However, in no case, is the auditor of either the appointing company or the disqualifying company expected to make any roving enquiries from such other companies in which the concerned director is also a director, as to whether or not they have committed any default in terms of sub clauses (A) and/ or (B) of clause (g) of section 274(1) of the Act.

34. The auditor should verify the information provided by the management and the directors from the information contained in the register maintained under section 303(1) of the Act. The said register contains various particulars relating to all the directors of the company including particulars in respect of the office of director, managing director, etc. The auditor can also examine the Form 32 filed by the company during the financial year under section 303(2) of the Act so as to know the changes, for example, appointment, retirement, resignation etc., of directors during the year. Form DD-A filed by the directors would also assist the auditor in assessing whether any director appointed during the year, at the time of appointed, was disqualified under section 274(1)(g) of the Act.

35. In case company being audited happens to be a public company which has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after 1<sup>st</sup> April, 1999; or has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more; then the auditor must report that all the directors are disqualified from being appointed as director in terms of clause (g) of sub-section (1) of section 274 of the Act. The auditor, in such a case, should also examine the return in Form DD-B to be filed

## **Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 III.119**

under the Rules. Form DD-B contains the particulars of directors during the relevant period.

36. Since the Rules are applicable to public limited companies only, Forms DD-A and DD-B would not be available to the auditor a private company. In such cases, the auditor's employs the same procedures to comply with the requirements of section 227(3)(f) which are applied by an auditor of a public company except that the auditor is not required to examine Forms DD-A and DD-B because of their non-availability in a private company.

37. The reporting under clause (f) of sub-section (3) of section 227 of the Act may be as follows, keeping in view the situation concerned:

- (a) Where all the directors of the company are able to produce the evidence as specified in paragraph 33 above that the public company/(ies) of which they are directors have not defaulted in terms of section 274(1)(g), the auditor may report as follows:

"On the basis of the written representations received from the directors, and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31<sup>st</sup> March, 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956".

- (b) In a situation where a director is unable to produce the written representation as specified in paragraph 33 above, the auditor may report as follows:

"Mr. X, who is also a director of ABC Ltd., has not produced written representation as to whether ABC Ltd., in which Mr. X is a director as on 31<sup>st</sup> March, 2XXX, had not defaulted in terms of section 274(1)(g) of the Companies Act, 1956. In the absence of this representation, we are unable to comment whether Mr. X is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274 of the Companies Act, 1956. As far as other directors are concerned, on the basis of the written representations received from such directors, and taken on record by the Board of Directors, we report that none of the remaining directors is disqualified as on 31<sup>st</sup> March, 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956."

- (c) Where on the basis of the written representation received from a director, it is noted that the director was disqualified from being appointed as a director

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under this clause, the auditor may report as follows:

"On the basis of the written representation received from Mr. Y, who is a director of ABC Ltd., as on 31<sup>st</sup> March 2XXX, and taken on record by the Board of Directors, we report that he is disqualified from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956.

As far as other directors are concerned, on the basis of the written representations received from such directors, and taken on record by the Board of Directors, we report that none of the remaining directors is disqualified as on 31<sup>st</sup> March 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956."

#### **Certificate under the Rules**

38. As mentioned, sub-rule (a) of Rule 4 requires that it shall be the duty of the statutory auditor to furnish a certificate each year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified for appointment as a director or not. The Rules, however, are silent as to whom the said certificate would be addressed. An interpretation could be that the auditor should furnish such a certificate to the shareholders of the company. However, this does not seem to be logical since the shareholders would get the same information from the auditor's statement in respect of clause (f) of sub-section (3) of section 227 of the Act. Therefore, it would be appropriate that the certificate is addressed to the Board of Directors of the Company. It may also be noted that the Rules are also silent as to the format and contents of the certificate. An illustrative format of the said certificate is given in **Appendix II**, which may be used by the auditors.

#### **Appendix I**

#### **PUBLISHED IN THE GAZETTE OF INDIA, PART II, SECTION 3(i), EXTRAORDINARY**

*Ministry of Finance*

#### **(Department of Company Affairs)**

#### **NOTIFICATION**

New Delhi, the 21<sup>st</sup> October, 2003

**G.S.R. 830 (E).**- In exercise of the powers conferred by clause (b) of sub-section (1) of section 642 of the Companies Act, 1956 (1 of 1956), the Central

## **Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 III.121**

Government hereby makes the following rules to carry out the purpose of clause (g) of sub-section (1) of section 274 of the said Act, namely :-

### **1. Short Title, Commencement and Extent**

- (1) These rules may be called the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003.
- (2) These rules shall come into force from the date of their notification in the Official Gazette.
- (3) These rules shall apply to all public limited companies registered under the Companies Act, 1956.

### **2. Definitions**

In these Rules, unless the context otherwise requires, -

- (a) "disqualifying company" is the company in which the default has occurred on account of which a director stands disqualified;
- (b) "appointing company" is the company in which an individual is seeking appointment as a director, including re-appointment as director.

### **3. Disqualifications under clause (g) of sub-section (1) of section 274 of the Companies Act, 1956**

- (a) Whenever a company fails to file the annual accounts and annual returns, as described in sub-clause (A) of clause (g) of sub-section (1) of section 274, persons who are directors on the last due date for filing the annual accounts and the annual returns for any continuous three financial years commencing on and after the first day of April, 1999, shall be disqualified.
- (b) If a company has failed to repay any deposit, irrespective of the enactment, rules or regulations under which the deposits have been accepted by the companies, or interest thereon, or redeem its debentures, or pay any dividend declared on the respective due dates, and if such failure continues for one year, as described in sub-clause (B) of clause (g) of sub-section (1) of section 274, then the directors of that company shall stand disqualified immediately on expiry of that one year from the respective due dates:

Provided that all the directors who have been directors in the relevant year, from the due date to the expiry of one year after the due date, will be disqualified:

Provided further that disqualification on account of the reasons cited under this Rule shall also apply to the reappointment as a director.

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*Explanation*-For the purpose of this rule, it is clarified that non-payment of dividend referred to in sub-clause (B) of clause (g) of sub-section (1) of section 274 due to the reason of dividend not being claimed or kept in separate bank account as required under section 205A of Companies Act, 1956 or paid into Investors Education & Protection Fund as required under section 205C of that Act shall not be deemed to be a failure to make payment of dividend.

#### **4. Duty of Statutory Auditor to Report on Disqualification**

- (a) It shall be the duty of statutory auditor of the appointing company as well as disqualifying company, as required under section 227(3)(f) to report to the members of the company whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274 and to furnish a certificate each year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified for appointment as a director or not.
- (b) It shall be the duty of the statutory auditors of the "disqualifying company" as required in section 227(3)(f) to report to the members of the company whether any director in the company has been disqualified during the year from being re-appointed as director, or being appointed as director in another company under clause (g), of sub-section (1) of section 274.

#### **5. Duty of Company to Intimate Disqualification**

Whenever a company fails to file the annual accounts and returns, or fails to repay any deposit, interest, dividend, or fails to redeem its debentures, as described in clauses (A) and (B) of clause (g) of sub-section (1) of section 274, the company shall immediately file a return in duplicate in Form 'DD-B', prescribed under these rules for this purpose, to the Registrar of Companies, furnishing therein the names and addresses of all the Directors of the company during the relevant financial years:

Provided that names of such directors who have been exempted from application of Section 274(1)(g) by the Central Government, from time to time, shall be excluded.

Provided further that no unusual abbreviations or short forms shall be used in filling up the Form 'DD-B', which shall give such details as may be necessary to distinguish and identify each director without any ambiguity.

**6. Failure to Intimate Disqualification Shall render Director as Officer in Default**

When a company fails to file the Form 'DD-B' as above within 30 days of the failure that would attract disqualification under Section 274(1)(g), officers of the company listed in section 5 of the Companies Act, 1956 shall be officers in default.

7.(a) Upon receipt of the Form 'DD-B' in duplicate under Rule 5, the Registrar of Companies shall immediately register the document and place one copy of it in the document file for public inspection.

(b) The Registrar of Companies shall forward the other copy to the Central Government.

**8. Names of the Disqualified Directors on the Website etc.**

(a) The Central Government shall place on the web site of the Department of Company Affairs the names and addresses and such other details including names and details of the companies concerned, as may be necessary, in respect of all the disqualified directors.

(b) The Central Government may also publicize the names of disqualified directors in such manner as it may consider appropriate.

(c) The Central Government shall take such steps as may be required to update its web-site to ensure that name of the person, in whose respect disqualification period has expired after 5 years, is deleted from the web-site.

**9. Duty of Every Director**

Every director in a public company registered under the Companies Act, 1956 shall file Form 'DD-A', prescribed under these Rules, before he is appointed or re-appointed.

10. If any question arises as to whether these rules are or are not applicable to a particular company, such question shall be decided by the Central Government.

**11. Punishment for Contravention of the Rules**

If a company or any other person contravenes any provision of these rules for which no punishment is provided in the Companies Act, 1956, the company and every officer of the company who is in default or such other person shall be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five

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hundred rupees for every day after the first, during which the contravention continues.

12. On the commencement of these rules, all rules, orders or directions in force in relation to any matter for which provision is made in these Rules shall stand repealed, except as respects things done or omitted to be done before such repeal.

[F. No.1/8/2002-CL.V]

Rajiv Mehrishi,  
Joint Secretary

#### FORM 'DD-A'

#### **Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003**

Intimation by Director

[Pursuant to Section 274(1)(g)]

Registration No. of Company \_\_\_\_\_

Nominal Capital Rs. \_\_\_\_\_

Paid-up Capital Rs. \_\_\_\_\_

Name of Company \_\_\_\_\_

Address of its Registered Office \_\_\_\_\_

To

The Board of Directors

of \_\_\_\_\_

I \_\_\_\_\_ son/daughter/wife of \_\_\_\_\_ resident of \_\_\_\_\_  
director/managing director/manager in the company hereby give notice that I  
am/was a director in the following companies during the last 3 years:

Name of the Company	Date of Appointment	Date of Cessation
1.....		
2.....		

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I further confirm that I have not incurred disqualification under section 274(1)(g) of the Companies Act, 1956 in any of the above companies, in the previous financial year, and that I, at present, stand free from any disqualification from being a director.

or

I further confirm that I have incurred disqualifications under section 274(1)(g) of the Companies Act, 1956 in the following company(s) in the previous financial year, and that I, at present stand disqualified from being a director.

Name of the Company	Date of Appointment	Date of Cessation
1.....		
2.....		

Signature  
(Full Name)

Dated this \_\_\_\_\_ day of \_\_\_\_\_

**FORM 'DD-B'**  
**Report by a Public Company**

[Pursuant to Section 274(1)(g) read with Rule 5 of Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003]

Registration No. of Company: \_\_\_\_\_

Nominal Capital Rs. \_\_\_\_\_

Paid-up Capital Rs. \_\_\_\_\_

Name of Company \_\_\_\_\_

Address of its Registered Office \_\_\_\_\_

To

The Registrar of Companies,

It is hereby reported under section 274(1)(g) of Companies Act, 1956, that M/s. \_\_\_\_\_ have failed to (i) file the annual accounts and annual returns for the last three financial years, or (ii) repay deposits or interest thereon on due date being \_\_\_\_\_ or redeem its debentures on due date being \_\_\_\_\_ or pay

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dividend declared by the company since \_\_\_\_\_ or both. The period of one year has expired on \_\_\_\_\_.

The name and address of directors at the relevant period are as under :-

- (a) Director's name in full, without abbreviations
- (b) Director's name as per company's records (abbreviations may be expanded and shown)
- (c) Address of the Director
  - (i) Permanent
  - (ii) Present
  
- (d) Positions held by the director in the last 5 years, prior to disqualification:

Signature  
Designation\*

Dated this \_\_\_\_\_ day of \_\_\_\_\_

\*State whether Director, Managing Director, Manager or Secretary

### Appendix II

#### **FORMAT OF THE CERTIFICATE TO BE ISSUED UNDER RULE 4 (a) OF THE COMPANIES (DISQUALIFICATION OF DIRECTORS UNDER SECTION 274(1)(g) OF THE COMPANIES ACT, 1956) RULES, 2003**

##### **Auditor's Certificate**

##### **Rule 4 (a) of the Companies (Disqualification of Directors Under section 274(1)(g) of the Companies Act, 1956) Rules, 2003**

To,

The Board of Directors of \_\_\_\_\_(name of the company)

In terms of Rule 4(a) of the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003, I/we ..... (name of the chartered accountant/ firm, as the case may be), based on our examination of the books and records of the company, carried out in accordance with the requirements of the Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956, issued by the Institute of Chartered Accountants of India, do hereby certify that none of the directors of the company, i.e., ..... (name of the company) as on \_\_\_\_\_ (date of the balance sheet) is disqualified for appointment as a director in the

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aforementioned company in terms of clause (g) of sub section (1) of section 274 of the Companies Act, 1956.

Date:

For XYZ & Co.,

Address:

Chartered Accountants

.....

(Signature)

(Name of the Member Signing the Certificate)

(Designation<sup>4</sup>)

.....

(Membership Number)

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<sup>4</sup> Partner or proprietor, as the case may be.

## **GUIDANCE NOTE ON COMPUTER ASSISTED AUDIT TECHNIQUES(CAATS)**

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### **INTRODUCTION**

1. The overall objectives and scope of an audit do not change when an audit is conducted in a computer information systems (CIS) environment. The application of auditing procedures may, however, require the auditor to consider techniques known as Computer Assisted Audit Techniques (CAATs) that use the computer as an audit tool for enhancing the effectiveness and efficiency of audit procedures. CAATs are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance, contained in an entity's information systems.

2. The purpose of this Guidance Note is to provide guidance in the use of CAATs. This Guidance Note describes computer assisted audit techniques including computer tools, collectively referred to as CAATs. This Guidance Note applies to all uses of CAATs when a computer of any type or size is involved whether that computer is operated by the entity or by a third party.

### **DESCRIPTION OF COMPUTER ASSISTED AUDIT TECHNIQUES (CAATS)**

3. Computer Assisted Audit Techniques (CAATs) are important tools for the auditor in performing audits. CAATs may be used in performing various auditing procedures, including the following:

- ◆ tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;
- ◆ analytical procedures, for example, identifying inconsistencies or significant fluctuations;
- ◆ tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management;

- ◆ sampling programs to extract data for audit testing;
- ◆ tests of application controls, for example, testing the functioning of a programmed control; and
- ◆ reperforming calculations performed by the entity's accounting systems.

4. CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software, and perform audit tests more efficiently. CAATs are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance contained in an entity's information systems. CAATs may consist of package programs, purpose-written programs, utility programs or system management program. Regardless of the origin of the programs, the auditor substantiates their appropriateness and validity for audit purposes before using them. A brief description of the programs commonly used is given below.

- ◆ *Package Programs* are generalized computer programs designed to perform data processing functions, such as reading data, selecting and analyzing information, performing calculations, creating data files and reporting in a format specified by the auditor.
- ◆ *Purpose-Written Programs* perform audit tasks in specific circumstances. These programs may be developed by the auditor, the entity being audited or an outside programmer hired by the auditor. In some cases, the auditor may use an entity's existing programs in their original or modified state because it may be more efficient than developing independent programs.
- ◆ *Utility Programs* are used by an entity to perform common data processing functions, such as sorting, creating and printing files. These programs are generally not designed for audit purposes, and therefore may not contain features such as automatic record counts or control totals.
- ◆ *System Management Programs* are enhanced productivity tools that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software. As with utility programs these tools are not specifically designed for auditing use and their use requires additional care.

Details of some of the techniques used are mentioned in the Appendix.

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#### **CONSIDERATIONS IN THE USE OF CAATS**

5. When planning an audit, the auditor may consider an appropriate combination of manual and computer assisted audit techniques. In determining whether to use CAATs, the factors to consider include:

- ◆ the IT knowledge, expertise and experience of the audit team;
- ◆ the availability of CAATs and suitable computer facilities and data;
- ◆ the impracticability of manual tests;
- ◆ effectiveness and efficiency; and
- ◆ time constraints.

Before using CAATs the auditor considers the controls incorporated in the design of the entity's computer systems to which CAAT would be applied in order to determine whether, and if so, how, CAATs should be used.

#### **IT KNOWLEDGE, EXPERTISE AND EXPERIENCE OF THE AUDIT TEAM**

6. Standard on Auditing (SA) 401, "Auditing in a Computer Information Systems Environment" deals with the level of skill and competence the audit team needs to conduct an audit in a CIS environment. It provides guidance when an auditor delegates work to assistants with CIS skills or when the auditor uses work performed by other auditors or experts with such skills. Specifically, the audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted. The level of knowledge required depends on "availability of CAATs" and "suitable computer facilities".

#### **AVAILABILITY OF CAATS AND SUITABLE COMPUTER FACILITIES**

7. The auditor considers the availability of CAATs, suitable computer facilities and the necessary computer-based information systems and data. The auditor may plan to use other computer facilities when the use of CAATs on an entity's computer is uneconomical or impractical, for example, because of an incompatibility between the auditor's package program and entity's computer. Additionally, the auditor may elect to use their own facilities, such as PCs or laptops.

8. The cooperation of the entity's personnel may be required to provide processing facilities at a convenient time, to assist with activities such as loading and running of CAAT on the entity's system, and to provide copies of data files in the format required by the auditor.

### **IMPRACTICABILITY OF MANUAL TESTS**

9. Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve amounts of data that would overwhelm any manual procedure. In addition, many computer information systems perform tasks for which no hard copy evidence is available and, therefore, it may be impracticable for the auditor to perform tests manually. The lack of hard copy evidence may occur at different stages in the business cycle.

- ◆ Source information may be initiated electronically, such as by voice activation, electronic data imaging, or point of sale electronic funds transfer. In addition, some transactions, such as discounts and interest calculations, may be generated directly by computer programs with no specific authorization of individual transactions.
- ◆ A system may not produce a visible audit trail providing assurance as to the completeness and accuracy of transactions processed. For example, a computer program might match delivery notes and suppliers' invoices.
- ◆ In addition, programmed controlled procedures, such as checking customer credit limits, may provide hard copy evidence only on an exception basis.
- ◆ A system may not produce hard copy reports. In addition, a printed report may contain only summary totals while computer files retain the supporting details.

### **EFFECTIVENESS AND EFFICIENCY**

10. The effectiveness and efficiency of auditing procedures may be improved by using CAATs to obtain and evaluate audit evidence. CAATs are often an efficient means of testing a large number of transactions or controls over large populations by:

- ◆ analyzing and selecting samples from a large volume of transactions;
- ◆ applying analytical procedures; and
- ◆ performing substantive procedures.

11. Matters relating to efficiency that an auditor might consider include:

- ◆ the time taken to plan, design, execute and evaluate CAAT;
- ◆ technical review and assistance hours;
- ◆ designing and printing of forms (for example, confirmations); and

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- ◆ availability of computer resources

12. In evaluating the effectiveness and efficiency of CAAT, the auditor considers the continuing use of CAAT application. The initial planning, design and development of CAAT will usually benefit audits in subsequent periods.

#### **TIME CONSTRAINTS**

13. Certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.

14. Where the time available to perform an audit is limited, the auditor may plan to use CAAT because its use will meet the auditor's time requirement better than other possible procedures.

#### **USING CAATS**

15. The major steps to be undertaken by the auditor in the application of CAAT are to:

- (a) set the objective of CAAT application;
- (b) determine the content and accessibility of the entity's files;
- (c) identify the specific files or databases to be examined;
- (d) understand the relationship between the data tables where a database is to be examined;
- (e) define the specific tests or procedures and related transactions and balances affected;
- (f) define the output requirements;
- (g) arrange with the user and IT departments, if appropriate, for copies of the relevant files or database tables to be made at the appropriate cut off date and time;
- (h) identify the personnel who may participate in the design and application of CAAT;
- (i) refine the estimates of costs and benefits;
- (j) ensure that the use of CAAT is properly controlled;
- (k) arrange the administrative activities, including the necessary skills and computer facilities;

- (l) reconcile data to be used for CAAT with the accounting and other records;
- (m) execute CAAT application;
- (n) evaluate the results;
- (o) document CAATs to be used including objectives, high level flowcharts and run instructions; and
- (p) assess the effect of changes to the programs/system on the use of CAAT.

### **TESTING CAAT**

16. The auditor should obtain reasonable assurance of the integrity, reliability, usefulness, and security of CAAT through appropriate planning, design, testing, processing and review of documentation. This should be done before reliance is placed upon CAAT. The nature, timing and extent of testing is dependent on the commercial availability and stability of CAAT.

### **CONTROLLING CAAT APPLICATION**

17. The specific procedures necessary to control the use of CAAT depend on the particular application. In establishing control, the auditor considers the need to:

- (a) approve specifications and conduct a review of the work to be performed by CAAT;
- (b) review the entity's general controls that may contribute to the integrity of CAAT, for example, controls over program changes and access to computer files. When such controls cannot be relied on to ensure the integrity of CAAT, the auditor may consider processing CAAT application at another suitable computer facility; and
- (c) ensure appropriate integration of the output by the auditor into the audit process.

18. Procedures carried out by the auditor to control CAATs applications may include:

- (a) participating in the design and testing of CAAT;
- (b) checking, if applicable, the coding of the program to ensure that it conforms with the detailed program specifications;
- (c) asking the entity's staff to review the operating system instructions to ensure that the software will run in the entity's computer installation;

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- (d) running the audit software on small test files before running it on the main data files;
- (e) checking whether the correct files were used, for example, by checking external evidence, such as control totals maintained by the user, and that those files were complete;
- (f) obtaining evidence that the audit software functioned as planned, for example, by reviewing output and control information; and
- (g) establishing appropriate security measures to safeguard the integrity and confidentiality of the data.

When the auditor intends to perform audit procedures concurrently with online processing, the auditor reviews those procedures with appropriate client personnel and obtains approval before conducting the tests to help avoid the inadvertent corruption of client records.

19. To ensure appropriate control procedures, the presence of the auditor is not necessarily required at the computer facility during the running of CAAT. It may, however, provide practical advantages, such as being able to control distribution of the output and ensuring the timely correction of errors, for example, if the wrong input file were to be used.

20. Audit procedures to control test data applications may include:

- ◆ controlling the sequence of submissions of test data where it spans several processing cycles;
- ◆ performing test runs containing small amounts of test data before submitting the main audit test data;
- ◆ predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total;
- ◆ confirming that the current version of the programs was used to process the test data; and
- ◆ testing whether the programs used to process the test data were the programs the entity used throughout the applicable audit period.

21. When using CAAT, the auditor may require the cooperation of entity staff with extensive knowledge of the computer installation. In such circumstances, the auditor considers whether the staff improperly influenced the results of CAAT.

22. Audit procedures to control the use of audit-enabling software may include:
- ◆ verifying the completeness, accuracy and availability of the relevant data, for example, historical data may be required to build a financial model;
  - ◆ reviewing the reasonableness of assumptions used in the application of the tool set, particularly, when using modeling software;
  - ◆ verifying availability of resources skilled in the use and control of the selected tools; and
  - ◆ confirming the appropriateness of the tool set to the audit objective, for example, the use of industry specific systems may be necessary for the design of audit programs for unique business cycles.

### **DOCUMENTATION**

23. The various stages of application of CAATs should be sufficiently documented to provide adequate audit evidence.

24. The audit working papers should contain sufficient documentation to describe CAAT application, including the details set out in the sections below:

#### **(a) Planning**

- ◆ CAAT objectives;
- ◆ CAAT to be used;
- ◆ Controls to be exercised; and
- ◆ Staffing, timing and cost.

#### **(b) Execution**

- ◆ CAAT preparation and testing procedures and controls;
- ◆ Details of the tests performed by CAAT;
- ◆ Details of inputs (e.g., data used, file layouts), processing (e.g., CAATs high-level flowcharts, logic) and outputs (e.g., log files, reports);
- ◆ Listing of relevant parameters or source code; and
- ◆ Relevant technical information about the entity's accounting system, such as file layouts.

#### **(c) Audit Evidence**

- ◆ Output provided;

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- ◆ Description of the audit work performed on the output;
- ◆ Audit findings; and
- ◆ Audit conclusions;

**(d) Other**

- ◆ Recommendations to the entity management; and

In addition, it may be useful to document suggestions for using CAAT in future years.

#### **ARRANGEMENTS WITH THE ENTITY**

25. The auditor may make arrangements for the retention of the data files, such as detailed transaction files, covering the appropriate audit time frame.

26. In order to minimize the effect on the organisation's production environment, access to the organisation's information system facilities, programs/systems and data should be arranged well in advance of the needed time period

27. The auditor should also consider the effect of these changes on the integrity and usefulness of CAAT, as well as the integrity of the programs/system and data used by the auditor.

#### **USING CAATS IN SMALL ENTITIES**

28. Although the general principles outlined in this Guidance Note apply in small entity IT environments, the following points need special consideration:

- (a) The level of general controls may be such that the auditor will place less reliance on the system of internal control. This will result in greater emphasis on tests of details of transactions and balances and analytical review procedures, which may increase the effectiveness of certain CAATs, particularly, audit software.
- (b) Where smaller volumes of data are processed, manual methods may be more cost effective.
- (c) A small entity may not be able to provide adequate technical assistance to the auditor, making the use of CAATs impracticable.
- (d) Certain audit package programs may not operate on small computers, thus restricting the auditor's choice of CAATs. The entity's data files may, however, be copied and processed on another suitable computer.

**Examples of Computer Assisted Audit Techniques**

<b>Techniques</b>	<b>Description</b>	<b>Advantages</b>	<b>Disadvantages</b>
Audit Automation	<ul style="list-style-type: none"> <li>◆ Expert Systems</li> <li>◆ Tools to evaluate a client's risk management procedures</li> <li>◆ Electronic working papers, which provide for the direct extraction of data from clients computer records</li> <li>◆ Corporate and financial modeling programs for use as predictive audit test</li> </ul>	<ul style="list-style-type: none"> <li>◆ These techniques are more useful when auditors are using laptops which can be directly linked with the entity's system.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Not applicable in the case of mainframe computers.</li> </ul>
Audit Software	<ul style="list-style-type: none"> <li>◆ Software used by the auditor to read data on client's files, to provide information for the audit and/or to re-perform procedures</li> </ul>	<ul style="list-style-type: none"> <li>◆ Performs a wide variety of audit tasks</li> <li>◆ Long term economies</li> <li>◆ Reads actual records</li> <li>◆ Capable of dealing with</li> </ul>	<ul style="list-style-type: none"> <li>◆ Requires a reasonable degree of skill to use</li> <li>◆ Initial set up costs can be high</li> <li>◆ Adaptation often needed from machine to machine</li> </ul>

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	carried out by the client's programs.	large volumes of transactions	
Core Image Comparison	Software used by the auditor to compare the executable version of a program with a secure master copy	<ul style="list-style-type: none"> <li>◆ Provides a high degree of comfort concerning the executable version of the program</li> <li>◆ Particularly useful where only executable versions are distributed</li> </ul>	<ul style="list-style-type: none"> <li>◆ Requires a high degree of skill to set up and to interpret the results.</li> <li>◆ Where programs have been recompiled the comparison may be invalidated as the program records everything as a difference</li> <li>◆ Printouts are hard to interpret and the actual changes made are difficult to establish</li> <li>◆ Availability restricted to certain machine types</li> </ul>
Database Analysers	Software used by the auditor to examine the rights associated with terminals and the ability of users to access information on a database	<ul style="list-style-type: none"> <li>◆ Provides detailed information concerning the operation of the database</li> <li>◆ Enhances the auditor's understanding of the database management system</li> </ul>	<ul style="list-style-type: none"> <li>◆ Requires a high degree of skill to set up and to interpret the results</li> <li>◆ Restricted availability both as regards machine types and database management systems</li> <li>◆ Specific and limited audit applicability</li> </ul>

## Guidance Notes on Computer Assisted Audit Techniques(CAATs) III. 139

<p>Embedded Code</p>	<p>Software used by the auditor to examine transactions passing through the system by placing his own program in the suite of programs used for processing.</p>	<ul style="list-style-type: none"> <li>◆ Performs a wide variety of audit tasks</li> <li>◆ Examines each transaction as it passes through the system</li> <li>◆ Operates continuously</li> <li>◆ Capable of identifying unusual transactions passing through the system.</li> </ul>	<ul style="list-style-type: none"> <li>◆ There is a processing overhead involved because of the extra programs</li> <li>◆ Definition of what constitutes an unusual transaction needs to be very precise</li> <li>◆ Precautions need to be taken over the output from the programs to ensure is security</li> <li>◆ Precautions need to be taken to ensure that the program cannot be suppressed or tampered with</li> <li>◆ Requires some degree of skill to use and to interpret the results</li> </ul>
<p>Log Analysers</p>	<p>Software used by the auditor to read and analyse records of machine activity</p>	<ul style="list-style-type: none"> <li>◆ Provides detailed information on machine usage.</li> <li>◆ Long term economies</li> <li>◆ Effective when testing integrity controls</li> </ul>	<ul style="list-style-type: none"> <li>◆ Requires a high degree of skill to use and to interpret the results</li> <li>◆ Limited availability as regards machine types</li> <li>◆ High volume of records restricts extent of test</li> </ul>
<p>Mapping</p>	<p>Software used by the auditor to list</p>	<ul style="list-style-type: none"> <li>◆ Identifies program</li> </ul>	<ul style="list-style-type: none"> <li>◆ Very specific objective</li> </ul>

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	unused program instructions	code which may be there for fraudulent reasons.	<ul style="list-style-type: none"> <li>◆ Requires a high degree of skill to use and to interpret the results</li> <li>◆ Adaptation needed from machine to machine.</li> </ul>
Modelling	A variety of software, usually associated with a microcomputer, enabling the auditor to carry out analytical reviews of client's results, to alter conditions so as to identify amounts for provisions or claims, or to project results and compare actual results with those expected	<ul style="list-style-type: none"> <li>◆ Can be a very powerful analytical tool</li> <li>◆ Can enable the auditor to examine provisions on a number of different bases</li> <li>◆ Very flexible in use</li> <li>◆ Can provide the auditor with useful information on trends and patterns</li> </ul>	<ul style="list-style-type: none"> <li>◆ A high volume of data may need to be entered initially</li> <li>◆ Results require careful interpretation</li> </ul>
On-line Testing	Techniques whereby the auditor arranges or manipulates data either real or fictitious, in order to see that a specific program or screen edit test is doing its work	<ul style="list-style-type: none"> <li>◆ Very widely applicable</li> <li>◆ Easy to use</li> <li>◆ Can be targetted for specific functions carried out by programs</li> </ul>	<ul style="list-style-type: none"> <li>◆ Each use satisfies only one particular objective</li> <li>◆ Care must be taken to ensure that "live" data does not impact actual results</li> </ul>

## Guidance Notes on Computer Assisted Audit Techniques(CAATs) III. 141

<p>Program Code Analysis</p>	<p>An examination by the auditor of the source code of a particular program with a view to following the logic of the program so as to satisfy himself that it will perform according to his understanding</p>	<ul style="list-style-type: none"> <li>◆ Gives a reasonable degree of comfort about the program logic</li> <li>◆ The auditor can examine every function of the program code</li> </ul>	<ul style="list-style-type: none"> <li>◆ The auditor must understand the program language</li> <li>◆ The auditor needs to check that the source code represents the version in the source library, and that this version equates to the executable version</li> </ul>
<p>Program Library Analysers</p>	<p>Software used by the auditor to examine dates of changes made to the executable library and the use of utilities to amend programs</p>	<ul style="list-style-type: none"> <li>◆ Provides the auditor with useful information concerning the program library</li> <li>◆ Identifies abnormal changes to the library</li> <li>◆ Useful when testing program security</li> </ul>	<ul style="list-style-type: none"> <li>◆ Requires a high degree of skill to use and to interpret the results</li> <li>◆ Availability restricted to certain machine types</li> <li>◆ Only relevant when testing integrity controls</li> </ul>
<p>Snapshots</p>	<p>Software used by the auditor to take a "picture" of a file of data or a transaction passing through the system at a particular point in time</p>	<ul style="list-style-type: none"> <li>◆ Permits the auditor to examine processing at a specific point in time to carry out tests, or to confirm the way a</li> </ul>	<ul style="list-style-type: none"> <li>◆ Can be expensive to set up</li> </ul>

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		particular aspect of the system operates	
Source Comparison	Software used by the auditor to compare the source version of a program with a secure master copy	<ul style="list-style-type: none"> <li>◆ Compares source code line by line and identifies all differences</li> <li>◆ Useful when testing integrity controls or particularly important program procedures</li> </ul>	<ul style="list-style-type: none"> <li>◆ Other procedures are necessary to ensure that the executable version reflects the source code examined</li> <li>◆ Requires some degree of skill to use and to interpret the results</li> <li>◆ Availability restricted to certain machine types</li> </ul>
Test Data - "Live", "Dead", Integrated Test Facility or Base Case System Evaluation	Fictitious data applied against the client's programs either whilst they are running or in an entirely separate operation. The results of processing the fictitious data are compared with the expected results based on the auditor's understanding of the programs involved	<ul style="list-style-type: none"> <li>◆ Performs a wide variety of tasks</li> <li>◆ Gives considerable comfort about the operation of programs</li> <li>◆ Can be precisely targeted for specific procedures within programs</li> <li>◆ Long term economies</li> </ul>	<ul style="list-style-type: none"> <li>◆ "Dead" test data requires additional work for the auditor to satisfy himself the right programs were used</li> <li>◆ Care must be taken to ensure that "live" data does not impact actual results</li> <li>◆ Technique can be expensive to set up and cumbersome to use</li> <li>◆ Adequate for detection of major error but less likely to detect deep-seated fraud</li> </ul>

### Guidance Notes on Computer Assisted Audit Techniques(CAATs) III. 143

Tracing	Software used by the auditor to identify which instructions were used in a program and in what order	<ul style="list-style-type: none"><li>◆ Helps to analyse the way in which a program operates</li></ul>	<ul style="list-style-type: none"><li>◆ There may be less costly ways to achieve the same objectives, although not in the same detail</li><li>◆ Requires a high degree of skill to use and to interpret the results</li><li>◆ Adaptation needed from machine to machine</li></ul>
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## GUIDANCE NOTE ON REPORTING UNDER SECTION 143(3)(f) AND (h) OF THE COMPANIES

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### Introduction

1. Section 143 of the Companies Act, 2013 (hereinafter referred to as the "Act") deals with the powers and duties of the auditors of companies. Section 143(1) of the Act requires the auditor to make certain specific enquiries during the course of the audit. Section 143(2) of the Act requires the auditor to, *inter alia*, give his report to the members of company on the accounts examined by him, and on every financial statement which are laid before the company in a general meeting. Sub-section (3) of section 143 of the Act also lays down certain matters required to be reported upon by the auditor in his report. Sub-section (3) of section 143 of Act provides as follows:

"(3) The auditor's report shall also state -

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (e) whether, in his opinion, the financial statements comply with the accounting standards;

## **Guidance Note on Section 143(f) and (h) of the Companies Act, 2013 III.145**

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- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- (g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- (i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;
- (j) such other matters as may be prescribed.<sup>1</sup>

### **Scope of the Guidance Note**

2. This Guidance Note is intended to assist the auditors in discharging their duties in respect of clauses (f) and (h) of sub-section (3) of section 143 of the Act. Clause (f) of the said sub-section creates a requirement for the auditor to consider observations or comments of the auditor on financial transactions or matters which have an adverse effect on the functioning of the company. Such observations or comments would ordinarily lead to the modification of or an emphasis of matter in the auditor's report on financial statements. It may be noted that the matters that lead to modification in the auditor's report on financial statements are matters that give rise to a qualified opinion, adverse opinion or a disclaimer of opinion<sup>2</sup>. Further, matters that lead to an emphasis of matter paragraphs are matters appropriately presented or disclosed in the financial statements that, in the auditor's judgement, are of such importance that they are fundamental to the users' understanding of the financial statements<sup>3</sup>. If the matter leading to the modification of the auditor's opinion or an emphasis of matter in the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company, the auditor is required to report such matter. Under clause (h) of sub-section (3) of section 143 of the Act, the auditor is required to state whether any matter leading to a qualification, reservation or adverse remark, that is, effectively the modification of the auditor's report on financial statements, relates to the maintenance of accounts and other matters connected therewith.

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<sup>1</sup> Refer Rule 11 of Companies (Audit and Auditors) Rules, 2014.

<sup>2</sup> Reference may be made to Standard on Auditing (SA) 705, "Modifications to the Opinion in the Independent Auditor's Report."

<sup>3</sup> Reference may be made to paragraphs 6 and 7 of Standard on Auditing (SA) 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report."

**Reporting under Section 143(3)(f) of the Act**

3. The relevant extracts of section 143(3)(f) of the Act are reproduced below:

“(3).The auditor’s report shall also state –

.....

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;”

4. Clause (f) requires the auditor to report "the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company". An auditor’s report may contain matters leading to modifications to the auditor’s opinion or emphasis of matter in the auditor’s report on the financial statements. Such matters may be related to issues which may have an adverse effect on the functioning of the company. The words "observations" or "comments" as appearing in clause (f) of section 143(3) are construed to have the same meaning as referring to "emphasis of matter paragraphs, situations leading to modification in the auditor’s report. Accordingly, the auditor should have made an "observation" or "comment" in the auditor’s report in order to determine the need to report under clause (f) of section 143(3). Therefore, only such "observations" or "comments" of the auditors on financial transactions or matters that have been made by the auditor in the auditor’s report which have an adverse effect on the functioning of the company are required to be reported under this clause. For the sake of clarity, it may be noted that neither the auditor’s observations nor the comments made by him have any adverse effect on the functioning of a company. These observations or comments made by the auditor might contain matters which might have an adverse effect on the functioning of a company.

5. The Act does not specify the meaning of the phrase 'adverse effect on the functioning of the company'. The expression should not be interpreted to mean that any event affecting the functioning of the company, observed by the auditor, should be reported upon even though it does not affect the financial statements, e.g., revocation of a license to manufacture one out of the many products during the year to which the financial statements relate, where such product that does not have any material contribution to the revenues of the company, etc. Such an interpretation would not only be beyond the scope of the audit of financial statements of the company but would also not be in accordance with the objective and concept of audit

## **Guidance Note on Section 143(f) and (h) of the Companies Act, 2013 III.147**

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stipulated under the Act. A more logical and harmonious interpretation is that this reporting requirement does not intend to change the basic objective and the concept of audit of financial statements of a company, which is to examine the financial statements with a view to express an opinion thereon.

6. The scope of the audit and auditor's role remains as contemplated under the Standards on Auditing (SAs) and other relevant pronouncements issued by the Institute of Chartered Accountants of India as well as laid down in the Act, i.e., to lend credibility to the financial statements by reporting whether they reflect a true and fair view. SA 200, *Objective of the Independent Auditor and the Conduct of an Audit in Accordance with Standards of Auditing*, specifies that the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form the opinion of the true and fair view of the financial position and operating result of an enterprise. The auditor's opinion, therefore, does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. SAs require auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. At this juncture, it may also be noted that SA 200 also clearly states that the concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.
7. There is no change in the objective and scope of an audit of financial statements because of inclusion of clause (f) in sub-section (3) of section 143 of the Act. The auditor expresses his opinion on the true and fair view presented by the financial statements through his report which may be modified in certain circumstances. However, the auditor would now have to

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evaluate the subject matters leading to modification of the audit report or emphasis of matter in the auditor's report to make judgement as to which of them has an adverse effect on the functioning of the company within the overall context of audit of financial statements of the company. Only such matters which, in the opinion of the auditor, have an adverse effect on the functioning of the company should be reported under this clause. Conversely, such qualifications or adverse opinions or disclaimer of opinion or emphasis of matters of the auditor, which do not deal with matters that have adverse effect on the functioning of the company, need not be reported under this clause.

8. As far as inquiries under section 143(1) are concerned, the auditor is not required to report on these matters unless he has any comments to make on any of the items referred to therein. If the auditor has any comments or observations on any of the matters stated in section 143(1), the auditor should consider such comments or observations when reporting under this clause if they contain matters that may have any adverse effect on the functioning of the company.
9. Auditor's will need to apply professional judgement in considering matters of emphasis that may have an adverse effect on the functioning of the company. Ordinarily matters that are pervasive in nature such as going concern or matters that will significantly impact the operations of the company due to its size and nature will need to be reported under clause (f) of sub-section (3) of section 143 of the Act. Examples of emphasis of matter which may have an adverse effect on the functioning of the company include situations where:
  - the going concern assumption is appropriate but there are several factors leading to a material uncertainty that may cast a significant doubt about the Company's ability to continue as a going concern; or
  - a material uncertainty regarding the outcome of a litigation wherein an unfavourable decision could result in a significant outflow of resources for the company, etc.

Examples of emphasis of matter which may not have an adverse effect on the functioning of the company include a situation where there is an emphasis of matter:

- on managerial remuneration which is subject to the approval of the Central Government;

## **Guidance Note on Section 143(f) and (h) of the Companies Act, 2013 III.149**

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- relating to accrual of a contractually receivable claim based on management estimate where the ultimate realisation could be different from the amount accrued;
  - on frauds that have been dealt with in the financial statements of the company and would not have any continuing effect on the financial statements.
10. Another issue which arises is whether any observations or comments made by the auditor under clause (i) of section 143(3) in respect of the company's internal financial controls over financial reporting, which may have any adverse effect on the functioning of the company, should also be reported in terms of this clause. In this regard, it is noted that reporting under section 143(3)(i) is part of the auditor's report though it may be reported in an annexure to the auditor's report. Accordingly, if any observations or comments made by the auditor on the adequacy or operating effectiveness of internal financial controls over financial reporting contain such matters, which, in his opinion, may have any adverse effect on the functioning of the company, should also be reported under clause (f) of section 143(3) even if such observation did not result in a modification to the audit opinion on the financial statements of the company. An example in this regard may be where an auditor reports that the company did not have an appropriate internal control system for inventory with regard to receipts, issue for production and physical verification.

### **Reporting under Section 143(3)(h) of the Act**

11. The relevant extracts of section 143(3)(h) of the Act are reproduced below:

“(3).The auditor's report shall also state –

.....

- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;”
12. Clause (h) requires the auditor to report "any qualification, reservation or adverse remark" relating to the maintenance of accounts and other matters connected therewith. An auditor's report may contain matters leading to modifications in the auditor's report on financial statements. The matters that cause such modification may have a consequential effects or possible effects on the books of account maintained by the company and other matters connected therewith.
13. Section 128 of the Act, *inter alia*, states that every company shall prepare and

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keep its books of account and other relevant books and papers and financial statements that give a true and fair view of the state of affairs of the company. Section 129(1) of the Act, *inter alia*, states that the financial statements shall comply with the accounting standards notified under section 133 of the Act. Section 2(13) of the Act defines "books of account" to include records maintained in respect of—

- (i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;
- (ii) all sales and purchases of goods and services by the company;
- (iii) the assets and liabilities of the company; and
- (iv) the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section;

Clause (b) of section 143(3) requires the auditor to, *inter alia*, state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books.

14. Matters to be reported under clause (h) of section 143(3) needs to be evaluated based on the financial statements prepared under the Act. This is also consistent with the other reporting responsibilities of the auditor on books of account and compliance with notified/specified accounting standards that are reported by him under section 143(3). Accordingly, reporting under this clause is determined based on the financial statements prepared i.e., as at the balance sheet date.
15. The words "qualification", "adverse remark" and "reservation" used in clause (h) of section 143(3) should be considered to be similar to the terms "qualified opinion", "adverse opinion" and "disclaimer of opinion", respectively, referred to in SA 705 "Modifications to the Opinion in the Independent Auditor's Report".
16. Accordingly, the auditor would need to report under clause (h) of section 143(3) any matter that causes a qualification, adverse remark or disclaimer of opinion on the financial statements since such matters will or possibly will have an effect on the books of account maintained by the company.
17. Further, reporting under clause (h) of section 143(3) will be required if the auditor makes any observation under clause (b) of section 143(3) relating to whether proper books of account as required by law have been kept by the company. For example, the auditor may have made an observation on

## **Guidance Note on Section 143(f) and (h) of the Companies Act, 2013 III.151**

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maintenance of cost records under clause (b) of section 143(3) and this may not have had an effect on the financial statements of the company or the auditor's opinion on the financial statements.

18. As a corollary, reporting under clause (h) of section 143(3) will not be required if there are no modifications, i.e., no qualified, adverse or disclaimer of opinion, and there are no such observations under clause (b) of section 143(3) regarding books of account kept by the company.
19. Since clause (h) of section 143(3) requires the auditor to report under this clause only if the auditor has "any qualification, reservation or adverse remark", it is appropriate to conclude that a matter reported under emphasis of matter paragraph in the audit report need not be considered for reporting under this clause as an emphasis of matter is not in the nature of a qualification, reservation (disclaimer) or adverse remark.
20. Any material weakness in internal financial controls that is reported by the auditor under clause (i) of section 143(3) may not have an impact on the maintenance of books of account if such material weakness did not result in a modification to the opinion on the financial statements of the company. However, if the material weakness in internal financial controls resulted in a modification to the audit opinion on the financial statements, then such modification may be covered for reporting under clause (h) of section 143(3) as stated in paragraph 17 above.
21. The Appendix to this Guidance Note contains illustrations on matters that may give rise to reporting under section 143(3)(f) and/or section 143(3)(h) of the Companies Act, 2013.

## **APPENDIX**

### **Illustrative Matters Forming Basis For Modified Opinion Or Emphasis Of Matter Paragraph in the Auditor's Report and Requiring Reporting Under Section 143(3)(f) and/or Section 143(3)(h) of the Companies Act, 2013**

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#### **ILLUSTRATION 1**

##### **Basis for Qualified Opinion**

The Company's inventories are carried in the Balance Sheet at Rs. XXX (*As at 31st March 20YY: Rs. YYY*). The Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a

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departure from the Accounting Standard - 2 "Valuation of Inventories". The Company's records indicate that had the Management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX (As at 31st March 20YY: Rs. YYY) would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX (Previous year ended 31st March, 20YY: Rs.YYY), and income tax, profit for the year and shareholders' funds would have been reduced by Rs. X, Rs. XX and Rs. XXX, respectively (Previous year ended 31st March, 20YY: Rs.Y, Rs.YY and Rs.YYY, respectively). This matter was also qualified in our report/ the report of the predecessor auditors on the financial statements for the year ended 31st March 20YY.<sup>4</sup>

#### Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion paragraph above, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31<sup>st</sup> March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

.....

.....

#### Report on Other Legal and Regulatory Requirements

As required by Section 143 (3) of the Act, we report that:

(a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit;

.....

.....

(f) The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

.....

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<sup>4</sup> Where applicable and only in such case, disclosure of previous year figures is required - Attention of the readers is drawn to the provisions of Standard on Auditing (SA) 710, *Comparative Information—Corresponding Figures And Comparative Financial Statements* .

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(h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above.”

### **ILLUSTRATION 2#**

#### **Opinion**

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31<sup>st</sup> March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

#### **Emphasis of Matters**

We draw attention to the following matters in the Notes to the financial statements:

- a) Note X to the financial statements which, describes the uncertainty related to the outcome of the lawsuit filed against the Company by XYZ Company.
- b) Note Y in the financial statements which indicates that the Company has accumulated losses and its net worth has been fully / substantially eroded, the Company has incurred a net loss/net cash loss during the current and previous year(s) and, the Company’s current liabilities exceeded its current assets as at the balance sheet date. These conditions, along with other matters set forth in Note Y, indicate the existence of a material uncertainty that may cast significant doubt about the Company’s ability to continue as a going concern. However, the financial statements of the Company have been prepared on a going concern basis for the reasons stated in the said Note.

Our opinion is not modified in respect of these matters.

.....

#### **Report on Other Legal and Regulatory Requirements**

As required by Section 143 (3) of the Act, we report that:

.....

- (f) The going concern matter described in sub-paragraph (b) under the Emphasis of Matters paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

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# In this case there is nothing reportable under sec 143(3)(h).

**ILLUSTRATION 3**

**Basis for Qualified Opinion**

ABC Company Limited’s investment in XYZ Company, a foreign associate whose net worth has been fully/substantially eroded, is carried at Rs. XXX in the Balance Sheet as at March 31, 20XX. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC Company Limited’s investment in XYZ Company as at March 31, 20XX because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

**Qualified Opinion**

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects<sup>5</sup> of the matter described in the Basis for Qualified Opinion paragraph, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31<sup>st</sup> March 20XX, and its profit/loss and its cash flows for the year ended on that date.

**Report on Other Legal and Regulatory Requirements**

As required by section 143 (3) of the Act, we report that:

.....  
.....

(f) The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

(h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above.

**ILLUSTRATION 4**

**Basis for Adverse Opinion**

The Company’s financing arrangements expired and the amount outstanding was

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<sup>5</sup> Note the use of words “possible effects” as the auditor was unable to obtain sufficient appropriate audit evidence.

## **Guidance Note on Section 143(f) and (h) of the Companies Act, 2013 III.155**

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payable on March 31, 20XX. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and, therefore, it may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

### **Adverse Opinion**

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give the information required by the Companies Act, 2013 in the manner so required and also do not give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31<sup>st</sup> March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

.....

### **Report on Other Legal and Regulatory Requirements**

As required by section 143 (3) of the Act, we report that:

.....

(f) The matter described in the Basis for Adverse Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

(h) The adverse remarks relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Adverse Opinion paragraph above.

### **ILLUSTRATION 5**

#### **Basis for Disclaimer of Opinion**

We were appointed as auditors of the Company after March 31, 20X1 and thus could not observe the counting of physical inventories at the beginning and end of the year. Accordingly, we were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 20X0 and March 31, 20X1 which are stated in the Balance Sheet at Rs. XXX and Rs. XXX, respectively.

In addition, the introduction of a new computerised accounts receivable system in September 20X0 resulted in numerous errors in accounts receivable. As of the date of our audit report, Management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by

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alternative means accounts receivable included in the Balance Sheet at a total amount of Rs. XXX as at March 31, 20X1.

As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable in the Balance Sheet, and the corresponding elements making up the Statement of Profit and Loss and Cash Flow Statement.

#### **Opinion**

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

#### **Report on Other Legal and Regulatory Requirements**

As required by section 143 (3) of the Act, we report that:

.....

.....

(f) The matter described in the Basis for Disclaimer of Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

(h) The reservation relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Disclaimer of Opinion paragraph above.