PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

PART – I : ACADEMIC UPDATE

(Legislative Amendments / Notifications / Circulars / Rules / Guidelines issued by Regulating Authority)

1. Ceiling on Number of Company Audits: As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies, other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.

2. Guidance Note on Reporting under Section 143(3)(f) and (h) of the Companies Act, 2013:

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;

(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.[1]

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[2]. 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[3]. 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.

[1] Refer Rule 11 of Companies (Audit and Auditors) Rules, 2014.

[2] Reference may be made to Standard on Auditing (SA) 705, "Modifications to the Opinion in the Independent Auditor's Report."

[3] 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 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 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;
   - 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 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 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

ILLUSTRATION 1

Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at ₹ XXX (*As at 31st March 20YY: ₹ 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 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 ₹ XXX (*As at 31st March 20YY: ₹ YYY*) would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by ₹ XXX (*Previous year ended 31st March, 20YY: ₹ YYY*), and income tax, profit for the year and shareholders’ funds would have been reduced by ₹ X, ₹ XX and ₹ XXX, respectively (*Previous year ended 31st March, 20YY: ₹ Y, ₹ YY and ₹ 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.[4]

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 31st 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.

……………………………

…………………………….

(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.”

[4] 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* .

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 31st 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.

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 ₹ 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

In this case there is nothing reportable under sec 143(3)(h).

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[5] 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 31st 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 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

[5] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.

state of affairs of the Company as at 31st 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 ₹ XXX and ₹ 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 alternative means accounts receivable included in the Balance Sheet at a total amount of ₹ 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.

3. Insurance Laws (Amendment) Act, 2015: The Ministry of Law and Justice has amended the Insurance Act, 1938, the General Insurance Business (Nationalisation) Act, 1972 and the Insurance Regulatory and Development Authority Act, 1999 through the Insurance Laws (Amendment) Act, 2015 dated 20^{th} March, 2015.

(i) According to section 2(9) of the Insurance Act, 1938, **'Insurer'** means-

(a) an Indian Insurance Company, or

(b) a statutory body established by an Act of Parliament to carry on insurance business, or

(c) an insurance co-operative society, or

(d) a foreign company engaged in re-insurance business through a branch established in India.

It may be noted that a "foreign company" shall mean a company or body established or incorporated under a law of any country outside India and includes Lloyd's established under the Lloyd's Act, 1871 (United Kingdom) or any of its Members.

(ii) According to section 2(7A) of the Insurance Act, 1938, **'Indian insurance company'** means any insurer, being a company which is limited by shares, and,-

(a) which is formed and registered under the Companies Act, 2013 as a public company or is converted into such a company within one year of the commencement of the Insurance Laws (Amendment) Act, 2015.

(b) in which the aggregate holdings of equity shares by foreign investors, including portfolio investors, does not exceed 49% of the paid up equity capital of such Indian Insurance company, which is Indian owned and controlled, in such manner as may be prescribed.

Here, the expression 'control' shall include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements.

(c) whose sole purpose is to carry on life insurance business or general insurance business or re-insurance business or health insurance business.

(iii) **Requirements as to the Minimum Paid-up Capital-** The minimum paid-up equity share capital of an Indian insurance company carrying on general insurance business should be ₹ 100 crores excluding preliminary expenses incurred in the formation and registration of company. The insurer may enhance the same in accordance with the provisions of the Companies Act, 2013, SEBI Act, 1992 and the rules, regulations or directions issued thereunder or any other law for the time being in force.

(iv) **Form and Contents of Financial Statements-** Section 11 of the Insurance Act, 1938 provides that every insurer, on or after the date of the commencement of the Insurance Laws (Amendment) Act, 2015, in respect of insurance business transacted by him and in respect of his shareholders' funds, shall, at the expiration of each financial year, prepare with reference to that year, balance sheet, a profit and loss account, a separate account of receipts and payments, a revenue account in accordance with the regulations as may be specified.

(v) **Unexpired Risks Reserve-** The need for Unexpired Risks Reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurers close their accounts on a particular date, not all risks under policies expire on that date. Many policies normally extend beyond this date into the following year during which risks continue. In other words, at the closing date, there is unexpired liability under various policies which may occur during the remaining term of the policy beyond the year end.

As per section 64V of the Insurance Act, 1938 as amended by Insurance Laws (Amendment) Act, 2015, for the purpose of compliance with the provisions of maintaining control level of solvency margin, a proper value of every item of liability of the insurer shall be placed in the manner as may be specified by the regulations made in this behalf.

(vi) **Solvency Margin-** Section 64VA of the Insurance Act, 1938 as amended by Insurance Laws (Amendment) Act, 2015 requires every insurer and re-insurer to maintain an excess of the value of assets over the amount of liabilities at all times which shall not be less than 50% of the amount of minimum capital as stated under section 6 (requirement as to capital) of the Act and arrived at in the manner specified by the regulations.

The Authority, by way of regulation, shall specify a level of solvency margin known as ‘control level of solvency’. However, in certain special circumstances, the authority may direct application of this provision with some modifications provided this shall not result in the control level of solvency being less than what is stipulated in above para.

If, at any time, an insurer or re-insurer does not maintain the required control level of solvency margin, he is required to submit a financial plan to the Authority indicating the plan of action to correct the deficiency. If, on consideration of the plan, the Authority finds it inadequate, the insurer has to modify the financial plan.

Maintenance of solvency margin has a great importance for an insurance company considering their size and nature of business and also involvement of public money.

Sub-section (2) of section 64VA states that if an insurer or re-insurer fails to comply with the prescribed requirement of maintaining excess of value of assets over amount of liabilities, it shall deemed to be insolvent and may be wound up by the Court on an application made by the authority.

4. <u>Income Computation and Disclosure Standards (ICDS):</u> Section 145 of the Income Tax Act, 1961 deals with the method of accounting.

Under section 145(1), income chargeable under the heads "Profits and gains of business or profession" or "Income from other sources" shall be computed in accordance with either the cash or mercantile system of accounting regularly employed by the assessee.

Section 145(2) empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards to be followed by any class of assessees or in respect of any class of income.

Accordingly, the Central Government has, in exercise of the powers conferred under section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assessees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or " Income from other sources". This notification shall come into force with effect from 1st April, 2015, and shall accordingly apply to the Assessment Year 2016-17 and subsequent assessment years.

All the notified ICDSs are applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts. In the case of conflict between the provisions of the Income-tax Act, 1961 and the notified ICDSs, the provisions of the Act shall prevail to that extent.

The Central Government has prescribed 10 Income Computation and Disclosure Standards (ICDSs) as under:

A. ICDS I relating to Accounting Policies.

B. ICDS II relating to Valuation of Inventories.

C. ICDS III relating to Construction Contracts.

D. ICDS IV relating to Revenue Recognition.

E. ICDS V relating to Tangible Fixed Assets.

F. ICDS VI relating to the Effects of Changes in Foreign Exchange Rates.

G. ICDS VII relating to Government Grants.

H. ICDS VIII relating to Securities.

I. ICDS IX relating to Borrowing Costs.

J. ICDS X relating to Provisions, Contingent Liabilities and Contingent Assets.

The above ICDSs are to be followed by all assessee following mercantile system of accounting. Therefore, it is clear that those assessees who are following cash system of accounting need not follow the ICDSs notified above.

5. Reporting under Companies (Auditor's Report) Order, 2015 [CARO, 2015]: The Central Government, after consultation with the Institute of Chartered Accountants of India, has issued the Companies (Auditor's Report) Order, 2015, (CARO, 2015) under section 143(11) of the Companies Act, 2013, dated 10th April, 2015. The requirements of the Order are supplemental to the existing provisions of section 143 of the Act regarding the auditor's report.

The Order is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein. For example, examination of the system of internal control is one of the basic audit procedures employed by the auditor. The fact that the Order requires a statement regarding the internal control system applicable to purchases of inventory and fixed assets, and sale of goods and services only is no justification for the auditor to conclude that an examination of internal control regarding the other areas of a company's business is not important or not required.

Applicability of the Order: The CARO, 2015 is an additional reporting requirement Order. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2O13.

However, the Order specifically exempts the following class of companies-

(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;

(ii) an insurance company as defined under the Insurance Act,1938;

(iii) a company licensed to operate under section 8 of the Companies Act;

(iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act;

(v) a small company as defined under clause (85) of section 2 of the Companies Act; and

(vi) a private limited company with a paid up capital and reserves not more than ₹ 50 lakh and which does not have loan outstanding exceeding ₹ 25 lakh from any bank or financial institution and does not have a turnover exceeding ₹ 5 crore at any point of time during the financial year.

Matters to be included in the Auditor's Report: Paragraph 3 of the Order requires the auditor to include a statement in the auditor's report on the following matters, namely-

(i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;

(b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.

(ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management;

(b) are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported;

(c) whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account.

(iii) whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 189 of the Companies Act. If so,

(a) whether receipt of the principal amount and interest are also regular; and

(b) if overdue amount is more than rupees one lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest.

(iv) is there an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services. Whether there is a continuing failure to correct major weaknesses in internal control system.

(v) in case the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules framed there under, where applicable, have been complied with? If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

(vi) where maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, whether such accounts and records have been made and maintained.

(vii) (a) is the company regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

(b) in case dues of income tax or sales tax or wealth tax or service tax or duty of customs or duty of excise or value added tax or cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not constitute a dispute).

(c) whether the amount required to be transferred to investor education and protection fund in accordance with the relevant provisions of the Companies Act, 1956 and rules made thereunder has been transferred to such fund within time.

(viii) whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year.

(ix) whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported.

(x) whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company.

(xi) whether term loans were applied for the purpose for which the loans were obtained.

(xii) whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Reasons to be Stated for Unfavourable or Qualified Answers: Where the answer to any of the questions referred to in paragraph 3 of the Order is unfavourable or qualified, in the auditor's report, the auditor shall also state the reasons for such unfavourable or qualified answer, as the case may be.

Further, where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.

Consequential Amendment to the Format of the Auditor’s Report of a Company: The Auditing and Assurance Standards Board has issued illustrative formats of the auditor’s report on financial statements of a company under the Companies Act, 2013. While reporting on the requirements of CARO, 2015, a reference thereto also needs be added in the main audit report under the “Report on Legal and Other Regulatory Matters” paragraph as follows:

“Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor’s Report) Order, 2015 (“the Order”), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

As required by Section 143(3) of the Act, we report that:

……………………….

……………………….”

6. Companies (Cost Records and Audit) Rules, 2014: The Central Government has amended the Companies (Cost Records and Audit) Rules, 2014 dated 31st December, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

Maintenance of Cost Records: Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006.

The said rule has divided the list of companies into regulated sectors and non-regulated sectors. Some of the companies/industry/sector/product/service prescribed under the said rule are given below:

(A) Regulated Sectors-

(i) Telecommunication services made available to users by means of any transmission or reception of signs, signals, images etc. (other than broadcasting services) and regulated by the Telecom Regulatory Authority of India.

(ii) Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003, other than for captive generation.

(iii) Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board.

(iv) Drugs and Pharmaceutical.

(v) Fertilisers.

(vi) Sugar and industrial alcohol.

(B) Non-Regulated Sectors-

(i) Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items.

(ii) Turbo jets and turbo propellers.

(iii) Tyres and Tubes.

(iv) Steel.

(v) Cement.

(vi) Production, import and supply or trading of following medical devices, such as heart valves; orthopaedic implants; pacemaker (temporary and permanent), etc. The rule excludes the foreign companies having only liaison offices.

As per Rule 5 of the Companies (Cost Records and Audit) Rules, 2014, every company under these rules including all units and branches thereof, shall, in respect of each of its financial year, is required to maintain cost records in Form CRA-1. The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

Additionally, as per clause (vi) to Paragraph 3 of the CARO, 2015, where maintenance of cost records has been specified by the Government under section 148(1) of the Companies Act, 2013, the auditor has to report whether such accounts and records have been made and maintained.

Applicability of Cost Audit: Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 states the provisions related to the applicability of cost audit depending on the turnover of the company as follows-

(i) Classes of companies specified under item (A) "Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 50 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 25 crore or more.

(ii) Classes of companies specified under item (B) "Non-Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 100 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 35 crore or more.

Casual Vacancy in the Office of a Cost Auditor: Any casual vacancy in the office of a Cost Auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within 30 days of occurrence of such vacancy and the company shall inform the central government in Form CRA-2 within 30 days of such appointment of cost auditor.

7. General Features of Cost Records: The following general features of the cost records to be maintained in the books of accounts as per Form CRA-1 pursuant to rule 5(1) of the Companies (Cost Records and Audit) Rules, 2014 have been amended by the Central Government *vide* notification dated 31st December, 2014-

(i) Material Costs- Proper records shall be maintained showing separately all receipts, issues and balances both in quantities and cost of each item of raw material required for the production of goods or rendering of services under reference.

The material receipt shall be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited by the taxing authorities) that can be quantified with reasonable accuracy at the time of acquisition. Finance costs incurred in connection with the acquisition of Material shall not form part of material cost.

Spares which are specific to an item of equipment shall not be taken to inventory, but shall be capitalized with the cost of the specific equipment. Cost of capital spares or insurance spares, whether procured with the equipment or subsequently, shall be amortised over a period, not exceeding the useful life of the equipment.

Normal loss or spoilage of material prior to reaching the factory or at places where the services are provided shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal. Where materials are accounted at standard cost, the price variances related to materials shall be treated as part of material cost.

The material cost of normal scrap or defectives which are rejects shall be included in the material cost of goods manufactured. The material cost of actual scrap or defectives, not exceeding the normal shall be adjusted in the material cost of good production. Material Cost of abnormal scrap or objectives shall not be included in material cost but treated as loss after giving credit to the realisable value of such scrap or defectives.

Material costs shall be directly traced to a cost object to the extent it is economically feasible or shall be assigned to the cost object on the basis of material quantity consumed or similar identifiable measure and valued as per above principles. Where the material costs are not directly traceable to the cost object, the same shall be assigned on a suitable basis like technical estimates.

Where a material is processed or part manufactured by a third party according to specifications provided by the buyer, the processing or manufacturing charges payable to the third party shall be treated as part of the material cost.

(ii) Employee Cost- Proper records shall be maintained in respect of employee costs in whole such a manner as to enable the company to book these expenses cost centre wise or department wise with reference to goods or services under reference and to furnish necessary particulars. Where the employees work in such a manner that it is not possible to identify them with any specific cost centre or service centre or department, the employees cost shall be apportioned to the cost centre or service centres or departments on equitable and reasonable basis and applied consistently.

Employee cost shall be ascertained taking into account the gross pay including all allowances payable along with the cost to the employer of all the benefits.

Bonus whether payable as a statutory minimum or on a sharing of surplus shall be treated as part of employee cost. Ex-gratia payable in lieu of or in addition to bonus shall also be treated as part of the employee cost.

Remuneration payable to Managerial Personnel including Executive Directors on the Board and other officers of a corporate body under a statute shall be considered as part of the employee cost of the year under reference whether the whole or part of the remuneration is computed as a percentage of profits. Remuneration paid to non-executive directors shall not form part of employee cost but shall form part of administrative overheads.

Where employee cost is accounted at standard cost, variances due to normal reasons related to employee cost shall be treated as part of employee cost. Variances due to abnormal reasons shall be treated as part of abnormal cost.

Any recovery from the employee towards any benefit provided, namely, housing shall be reduced from the employee cost. Any change in the cost accounting principles applied for the determination of the employee cost shall be made only if it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an enterprise.

Where the employee services are traceable to a cost object, such employees' cost shall be assigned to the cost object on the basis such as time consumed or number of employees engaged or other related basis or similar identifiable measure. While determining whether a particular employee cost is chargeable to a separate cost object, the principle of materiality shall be adhered to.

Overtime premium shall be assigned directly to the cost object or treated as overheads depending on the economic feasibility and the specific circumstance requiring such overtime. Idle time cost shall be assigned direct to the cost object or treated as overheads depending on the economic feasibility and the specific circumstances causing such idle time.

(iii) Utilities- Proper records shall be maintained showing the quantity and cost of each major utility such as power, water, steam, effluent treatment and other related utilities produced and consumed by the different cost centres in such detail as to have particulars for each utility separately.

Cost of utilities purchased shall be measured at cost of purchase including duties and taxes, transportation cost, insurance and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified with reasonable accuracy at the time of acquisition.

Cost of self-generated utilities for own consumption shall comprise direct material cost, direct employee cost, direct expenses and factory overheads. In case of utilities generated for the purpose of inter unit transfers, the distribution cost incurred for such transfers shall be added to the cost of utilities determined as above. Cost of utilities generated for the intercompany transfers shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost and share of administrative overheads.

Where cost of utilities is accounted at standard cost, the price variances related to utilities shall be treated as part of cost of utilities and the portion of usage variances due to normal reasons shall be treated as part of cost of utilities. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.

Any subsidy or grant or incentive or any such payment received or receivable with respect to any cost of utilities shall be reduced for ascertainment of the cost to which such amounts are related.

(iv) **Direct Expenses-** Proper records shall be maintained in respect of direct expenses in such a manner as to enable the company to book these expenses cost centre wise or cost object or department wise with reference to goods or services under reference and to furnish necessary particulars.

Direct expenses incurred for the use of bought out resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of trade discounts, rebates, taxes and duties refundable or to be credited. Other direct expenses shall be determined on the basis of amount incurred on connection therewith.

(v) **Repairs and Maintenance-** Proper records showing the expenditure incurred by the workshop, tool room and on repairs and maintenance in the various cost centres or departments shall be maintained under different heads.

Repairs and maintenance cost shall be the aggregate of direct and indirect cost relating to repairs and maintenance activity. Direct cost shall include the cost of materials, consumable stores, spares, manpower, equipment usage, utilities and other Identifiable resources consumed in such activity. Indirect cost shall include the cost of resources common to various repairs and maintenance activities such as manpower, equipment usage and other costs allocable to such activities.

Cost of in-house repairs and maintenance activity shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such activity.

Cost of repairs and maintenance activity carried out by outside contractors inside the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other costs incurred by the entity for such jobs.

Each type of repairs and maintenance shall be treated as a distinct activity, in material and identifiable. Cost of repairs and maintenance activity shall be measured for each major asset category separately.

Cost of spares replaced which do not enhance the future economic benefits from the existing asset beyond its previously assessed standard of performance shall be included under repairs and maintenance cost.

Where the repairs and maintenance cost is not directly traceable to cost object, it shall be assigned based on either of the following the principles of (1) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost and (2) Benefits received - overheads are to be apportioned to the various cost objects in proportion to the benefits received by them. If the repairs and maintenance cost (including the share of the cost of reciprocal exchange of services) is shared by several cost objects, the related cost shall be measured as an aggregate and distributed among the cost objects.

(vi) Fixed Assets and depreciation- Proper and adequate records shall be maintained for assets used for production of goods or rendering of services under reference n respect of which depreciation has to be provided for. These records shall, *inter-alia*, indicate grouping of assets under each good or service, the cost of acquisition of each item of asset including installation charges, date of acquisition and rate of depreciation.

The minimum amount of depreciation to be provided shall not be less than the amount calculated as per principles and methods as prescribed by any law or regulations applicable to the entity and followed by it.

Spares purchased specifically for a particular asset, or class of assets, and which would become redundant if that asset or class of asset was retired or use of that asset was discontinued, shall form part of that asset. The depreciable amount of such spares shall be allocated over the useful life of the asset.

Cost of small assets shall be written off in the period in which they were purchased as per the accounting policy of the entity.

(vii) Overheads- Overheads representing procurement of resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited.

Overheads other than those referred to above shall be determined on the basis of cost incurred in connection therewith. Any abnormal cost where it is material and quantifiable shall not form part of the overheads.

Finance costs incurred in connection with procured or self-generated resources shall not form part of overheads. Marketing overheads that can be identified to a product or service shall be assigned to that product or service.

(viii) Administrative Overheads- Administrative overheads shall be the aggregate of cost of resources consumed in activities relating to general management and administration of an organisation.

In case of leased assets, if the lease is an operating lease, the entire rentals shall be included in the administrative overheads. If the lease is a financial lease, the finance cost portion shall be segregated and treated as part of finance costs.

The cost of software (developed in house, purchased, licensed or customised), including up-gradation cost shall be amortised over its estimated useful life.

The cost of administrative services procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited.

Any subsidy or grant or incentive or any amount of similar nature received or receivable with respect to any administrative overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related. Administrative overheads shall not include any abnormal administrative cost.

Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the administrative overheads.

(ix) **Transportation Cost-** Proper records shall be maintained for recording the actual cost of transportation showing each element of cost such as freight, cartage, transit insurance and others after adjustment for recovery or transportation cost. Abnormal costs relating to transportation, if any, are to be identified and recorded for exclusion of computation of average transportation cost.

In case of a manufacturer having his own transport fleet, proper records shall be maintained to determine the actual operating cost of vehicles showing details of various elements of cost, such as salaries and wages of driver, cleaners and others, cost of fuel, lubricant grease, amortized cost of tyres and battery, repairs and maintenance, depreciation of the vehicles, distance covered and trips made, goods hauled and transported to the depot.

In case of hired transport charges incurred for despatch of goods, complete details shall be recorded as to date of despatch, type of transport used, description of the goods, destination of buyer, name of consignee, challan number, quantity of goods in terms of weight or volume, distance involved, amount paid and other related details.

(x) **Royalty and Technical Know-how-** Adequate records shall be maintained showing royalty or technical know-how fee including other recurring or non-recurring payments of similar nature, if any, made for the goods or services under reference to collaborators or technology suppliers in terms of agreements entered into with them.

Royalty and technical know-how fee paid or incurred in lump-sum or which are in the nature of 'one-time' payment, shall be amortised on the basis of the estimated output or benefit to be derived from the related asset. Amortisation of the amount of royalty or technical know-how fee paid for which the benefit is ensued in the current or future periods shall be determined based on the production or service volumes estimated for the period over which the asset is expected to benefit the entity.

Amount of the royalty and technical know-how fee shall not include finance costs and imputed costs. Any subsidy or grant or incentive or any such payment received or receivable with respect to amount of royalty and technical know-how fee shall be reduced to measure the amount of royalty and technical know-how fee.

(xi) **Research and Development Expenses-** Research and development costs shall include all the costs that are directly traceable to research or development activities or that can be assigned to research and development activities strictly on the basis of (a) cause and effect or (b) benefits received.

(xii) **Quality control expenses-** Adequate records shall be maintained to indicate the expenses incurred in respect of quality control department or cost centre or service centre for goods or services under reference. Where these services are also utilized for other goods or services of the company, the basis of apportionment to goods or services under reference and to other goods or services shall be on equitable and reasonable basis and applied consistently.

(xiii) Pollution control expenses- Adequate records shall be maintained to indicate the expenses incurred in respect of pollution control. The basis of apportionment to goods or services under reference and to other goods or services shall be on equitable and reasonable basis and applied consistently.

Pollution control costs shall be the aggregate of direct and indirect cost relating to pollution control activity. Direct cost shall include the cost of materials, consumable stores, spares, manpower, equipment usage, utilities, resources for testing and certification and other identifiable resources consumed in activities such as waste processing, disposal, remediation and others. Indirect cost shall include the cost of resources common to various pollution control activities such as pollution control registration and such like expenses.

(xiv) Service department expenses- Proper records shall be maintained in respect of service departments, that is, cost centres which primarily provide auxiliary services across the enterprise, to indicate expenses incurred in respect of each such service cost centre like engineering, work shop, designing, laboratory, safety, transport, computer cell, welfare and other related centres.

Each identifiable service cost centre shall be treated as a distinct cost object for measurement of the cost of services subject to the principle of materiality.

Cost of service cost centre shall be the aggregate of direct and indirect cost attributable to services being rendered by such cost centre. Cost of in-house services shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such service. Cost of other resources shall include related overheads. Cost of services rendered by contractors within the facilities of the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources provided to the contractors for such services.

(xv) Packing expenses- Proper records shall be maintained separately for domestic and export packing showing the quantity and cost of various packing materials and other expenses incurred on primary or secondary packing indicating the basis of valuation.

The packing material receipts shall be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified at the time of acquisition.

Finance costs directly incurred in connection with the acquisition of packing material shall not form part of packing material cost.

Self manufactured packing materials shall be valued including direct material cost, direct employee cost, direct expenses, job charges, factory overheads including share of administrative overheads comprising factory management and administration and share of research and development cost incurred for development and improvement of existing process or product.

(xvi) Interest and financing charges- Interest and financing charges are costs incurred by an enterprise in connection with the borrowing of fund or other costs which in effect represent payment for the use of non-equity fund.

Interest and financing charges incurred shall be identified for-

(I) acquisition or construction or production of qualifying assets including fixed assets; and

(II) other finance costs for production of goods or operations or services rendered which cannot be classified as qualifying assets.

Interest and financing charges directly attributable to the acquisition or construction or production of a qualifying asset shall be included in the cost of the asset. The charges shall not include imputed costs.

Subsidy or grant or incentive or amount of similar nature received or receivable with respect to interest and financing Charges, if any, shall be reduced to ascertain the net interest and financing charges.

(xvii) Any other item of cost- Proper records shall be maintained for any other item of cost being indispensable and considered necessary for inclusion in cost records for calculating cost of production of goods or rendering of services, cost of sales, margin in total and per unit of the goods or services under reference.

(xviii) Capacity determination- Capacity shall be determined in terms of units of production or equivalent machine or man hours.

Installed capacity is determined based on-

(I) manufacturers' technical specifications;

(II) capacities of individual or interrelated production centres;

(III) operational constraints or capacity of critical machines; or

(IV) number of shifts.

In case manufacturers' technical specifications are not available, the estimates by technical experts on capacity under ideal conditions shall be considered for determination of installed capacity. In case any production facility is added or discarded the installed capacity shall be reassessed from the date of such addition or discard. In case the same is reassessed as per direction of the Government, it shall be in accordance with the principles laid down in the said directives. In case of improvement in the production process, the installed capacity shall be reassessed from the date of such improvement.

Normal capacity shall be determined *vis-a-vis* installed capacity after carrying out adjustments for-

(I) holidays, normal shut down days and normal idle time;

(II) normal time lost in batch change over;

(III) time lost due to preventive maintenance and normal break downs of equipments;

(IV) losing efficiency due to ageing of the equipment; or

(V) number of shifts;

Capacity utilization is actual production measured as a percentage of installed capacity.

(xix) **Work-in-progress and finished stock-** The method followed for determining the cost of work-in-progress and finished stock of the goods and for services under delivery or in-process shall be appropriate and shall be indicated in the cost records so as to reveal the cost element that have been taken into account in such computation. All conversion costs incurred in bringing the inventories to their present location and condition shall be taken into account while computing the cost of work-in-progress and finished stock. The method adopted for determining the cost of work in progress and finished goods shall be followed consistently.

(xx) **Captive consumption-** If the goods or services under reference are used for captive consumption, proper records shall be maintained showing the quantity and cost of each such goods or services transferred to other departments or cost centres or units of the company for self-consumption and sold to outside parties separately.

(xxi) **By-Products and Joint Products-** Proper records shall be maintained for each item of by-product, if any, produced showing the receipt, issues and balances, both in quantity and value. The basis adopted for valuation of by-product for giving credit to the respective process shall be equitable and consistent and shall be indicated in cost records. Records showing the expenses incurred on further processing, if any, and actual sales realisation of by-product shall be maintained. The proper records shall be maintained in respect of credits or recoveries from the disposal of by-products.

Proper records shall be maintained the cost up to the point of separation of products or services shall be apportioned to joint products or services on reasonable and equitable basis and shall be applied consistently. The basis on which such joint costs are apportioned to different products or services arising from the process shall be indicated in the cost records. Proper records shall be maintained in respect credits or recoveries from the disposal of joint products or services.

(xxii) **Adjustment of cost variances-** Where the company maintains cost records on any basis other than actual such as standard costing, the records shall indicate the procedure followed by the company in working out the cost of the goods or services under such system. The cost variances shall be shown against separate heads and analyzed into material, labour, overheads and further segregated into quantity, price and efficiency variances. The method followed for adjusting the cost variances in determining the actual cost of the goods or services shall be indicated clearly in the cost records. The reasons for the variances shall be duly explained in the cost records and statements.

(xxiii) **Reconciliation of cost and financial accounts-** The cost statements shall be reconciled with the financial statements for the financial year specifically indicating the expenses or incomes not considered in the cost records or statements so as to ensure accuracy and to adjust the profit of the goods or services under reference with the overall profit of the Company. The variations, if any, shall be clearly indicated and explained.

(xxiv) **Related party transactions-** Related Party means related party as defined under clause (76) of section 2 of the Companies Act 2013.

'Normal' price means price charged for comparable and similar products in the ordinary course of trade and commerce where the price charged in the sole consideration of sale and such sale is not made to a related party. Normal price can be construed to be a price at which two unrelated and non-desperate parties would agree to a transaction and where such transaction is not clouded due to the proximity of the parties to the transaction and free from influence though the parties may have shared interest.

In respect of related party transactions or supplies made or services rendered by a company to a company termed 'related party relationship' and vice-a-versa, records shall be maintained showing contracts entered into, agreements or understanding reached in respect of-

(I) purchase and sale of raw materials, finished goods, rendering of services, process materials and rejected goods including scraps and other related materials;

(II) utilisation of plant facilities and technical know-how;

(III) supply of utilities and any other services;

(IV) administrative, technical, managerial or any other consultancy services;

(V) purchase and sale of capital goods including plant and machinery; and

(VI) any other payment related to the production of goods or rendering of services under reference.

(xxv) **Expenses or incentives on exports-** Proper records showing the expenses incurred on the export sales, if any, of the goods or services under reference shall be separately maintained so that the cost of export sales can be determined correctly. Separate cost statements shall be prepared for goods or services exported giving details of export expenses incurred or incentive earned.

Proper records shall be maintained giving the details of export commitments license-wise and the fulfillment of these commitments giving the reasons for non-compliance, if any. In case, duty free imports are made, the cost statements shall reflect this fact. If the duty free imports have been made after actual production, the statement shall reflect this fact also.

(xxvi) **Production Records-** Quantitative records of all finished goods (packed or unpacked) or services rendered showing production, issues for sales and balances of different type of the goods or services under reference, shall be maintained. The quantitative details of production of goods or services rendered shall be maintained separately for self-produced, third party on job work, loan license basis etc.

(xxvii)**Sales records-** Separate details of sales shall be maintained for domestic sales at control price, domestic sales at market price, export sales under advance license, export sales under other obligations, export sales at market price, and sales to related party or inter unit transfer. In case of services details of domestic delivery or sales at control price, domestic delivery or sales at market price, export delivery or sales under advance license, export delivery or sales under other obligations, export delivery or sales at market price, and delivery or sales to related party or inter unit transfer. Such details shall be maintained separately for each plant or unit wise or service center wise for total as well as per unit sales realization.

(xxviii)**Cost statements-** Cost statements (monthly, quarterly and annually) showing quantitative information in respect of each good or service under reference shall be prepared showing details of available capacity, actual production, production as per excise records, capacity utilization (in-house), stock purchased for trading, stock and other adjustments, quantity available for sale, wastage and actual sale during current financial year and previous year.

Such statements shall also include details in respect of all major items of costs constituting cost of production of goods or services, cost of sales of goods or services and margin in total as well as per unit of the goods or services. The goods or services emerging from a process, which forms raw material or an input material or service for a subsequent process, shall be valued at the cost of production or cost of service up to the previous stage.

Cost Statements in respect of reconciliation of indirect taxes showing details of total clearances of goods or services, assessable value, duties or taxes paid, CENVAT or VAT or Service Tax credit utilized, duties or taxes recovered and interest or penalty paid.

If the company is operating more than one plant, factory or service centre, separate cost statements as specified above shall be prepared in respect of each plant, factory or service centre.

(xxix)**Statistical Records-** The records regarding available machine hours or direct labour hours in different production departments and actually utilized shall be maintained for production of goods or rendering of services under reference and shortfall suitably analyzed. Suitable records for computation of idle time of machines or labour shall also be maintained and analyzed.

Proper records shall be maintained to enable the company to identify the capital employed, net fixed assets and working capital separately for the production of goods or rendering of services under reference and other goods or services to the extent such elements are separately identifiable. Non-identifiable items shall be allocated on a suitable and reasonable basis to different goods or services. Fresh investments on fixed assets for production of goods or rendering of services under reference that have not contributed to the production of goods or rendering of services during the relevant period or year shall be indicated in the cost records. The records shall, in addition, show assets added as replacement and those added for increasing existing capacity.

(xxx) **Records of Physical Verification-** Records of physical verification may be maintained in respect of all items held in the stock such as raw materials, process materials, packing materials, consumables stores, machinery spares, chemicals, fuels, finished goods and fixed assets etc. Reasons for shortages or surplus arising out of such verifications and the method followed for adjusting the same in the cost of the goods or services shall be indicated in the records.

8. <u>General Features of Cost Audit Report:</u>

1. (i) I/We have/have not obtained all the information and explanations, which to the best of my/ our knowledge and belief were necessary for the purpose of this audit.

   (ii) In my/our opinion, proper cost records, as per rule 5 of the Companies (Cost Records and Audit) Rules, 2014, have/have not been maintained by the company in respect of good(s)/service(s) under reference;

   (iii) In my/our opinion, proper returns adequate for the purpose of Cost Audit have/have not been received from the branches not visited by me/us.

   (iv) In my/our opinion and to the best of my/our information, the said books and records give/do not give the information required by the Companies Act, 2013, in the manner so required.

   (v) In my/our opinion, company has/does not have adequate system of internal audit of cost records which to my/our opinion is commensurate to its nature and size of its business.

   (vi) In my/our opinion, information, statements in the annexure to this cost audit report gives/does not give a true and fair view of the cost of production of good(s)/rendering of service(s), cost of sales, margin and other information relating to good(s)/service(s) under reference.

   (vii) Detailed unit-wise and product/service-wise cost statements and schedules thereto in respect of the product/service under reference of the company duly audited and certified by me/us are/are not kept in the company.

2. If as a result of the examination of the books of account, the cost auditor desires to point out any material deficiency or give a qualified report, he/she shall indicate the same against the relevant para (i) to (vii) in the prescribed form of the Cost Audit Report giving details of discrepancies he/she has come across.

3. The report, suggestions, observations and conclusions given by the cost auditor shall be based on verified data, reference to which shall be made here and shall, wherever practicable, be included after the company has been afforded an opportunity to comment on them.

PART – II : QUESTIONS AND ANSWERS

QUESTIONS

Standards on Auditing, Statements and Guidance Notes

1. The directors of Chirag Ltd. are concerned about the reliability and usefulness of the monthly financial management information that they receive.

   As a result, the company's auditors have been engaged to review the system and the information it generates, and to report their conclusions.

   (a) What an ordinary procedure includes for the review of financial statements?

   (b) Contrast this assignment with the statutory audit of the company's financial statements with regard to the scope of the assignment and to the report issued.

2. (a) Gama Ltd. is a mobile phone operating company. Barring the marketing function it had outsourced the entire operations like maintenance of mobile infrastructure, customer billing, payroll, accounting functions, etc. Assist the auditor of Gama Ltd. as to how he can obtain an understanding of how Gama Ltd. uses the services of the outsourced agency in its operations.

   (b) While verifying the employee records in a company, it was found that a major portion of the labour employed was child labour. On questioning the management, the auditor was told that it was outside his scope of the financial audit to look into the compliance with other laws. Comment.

   (c) Lakshya Ltd. has a branch office located outside India. Company is in the process of appointment of non-Chartered Accountant as an auditor but otherwise qualified person from country where the branch office is situated. Statutory auditor is of the opinion that non-Chartered Accountant cannot be appointed as branch auditor. Comment.

   You are also required to discuss the applicability of SA 600 using the work of another auditor by the head office auditor in regard to branch located outside India, if non-Chartered Accountant is appointed.

Audit Strategy, Planning and Programming

3. (a) As an internal auditor for a large manufacturing concern, you are asked to verify whether there are adequate records for identification and value of Plant and Machinery, tools and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit programme for the above.

   (b) M/s Abu & Co. was appointed as auditor of Grand Airways Ltd. As the audit partner, what factors shall be considered in the development of overall audit plan?

Risk Assessment and Internal Control

4. (a) Yex Ltd. has five entertainment centers to provide frivolous facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kms. Collections are made in cash. Specify the adequate control system towards collection of money.

(b) Briefly explain the corporate responsibility as envisaged under Sarbanes-Oxley Act of 2002.

Audit under CIS Environment

5. (a) Saras, a limited company having turnover of approximately ₹ 80 crores uses a tailor made accounting software package. In the said package, all transactions are recorded, processed and the final accounts generated from the system. The management tells you that in view of the voluminous nature of day books, there is no need to print them and that audit can be conducted on the computer itself. The management further assures you that any 'query based reports' as required can be generated and printed. As a statutory auditor of the company, enumerate the procedures you would adopt to conduct the audit.

(b) "The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability" – Comment.

The Company Audit & Audit Report

6. M/s SSS & Co. is an audit firm having partners CA. Satyam, CA. Shivam and CA. Sundaram. CA. Satyam, CA. Shivam and CA. Sundaram are holding appointment as an auditor in 4, 6 and 10 companies respectively.

(a) Provide the maximum number of audits remaining in the name of M/s SSS & Co.

(b) Provide the maximum number of audits remaining in the name of individual partner i.e. CA. Satyam, CA. Shivam and CA. Sundaram.

(c) Can M/s SSS & Co. accept the appointment as an auditor in 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company?

(d) Would your answer be different, if out of those 60 private companies, 45 companies are having paid-up share capital of ₹ 110 crore each?

7. CA. Rock is a partner in M/s Ajay & Associates and M/s Vijay & Associates simultaneously. M/s Ajay & Associates has completed its tenure of 10 years as an auditor in Sanjay Ltd. immediately preceding the current financial year. It may be noted that the provisions for applicability of rotation of auditors are applicable to Sanjay Ltd. Now, the company wants to appoint M/s Vijay & Associates as auditor for 5 years.

(a) Whether M/s Vijay & Associates is allowed to accept the appointment as auditor of Sanjay Ltd.?

(b) Would your answer be different from above if CA. Rock, being in-charge of M/s Ajay & Associates and certifying authority of financial statements of Sanjay Ltd., retires from the partnership in M/s Ajay & Associates and joins M/s Vijay & Associates?

8. (a) FX Ltd. is engaged in the business of newspaper and radio broadcasting. It operates through different brand names. During the Financial Year 15-16, it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The

company expects to benefits by this expenditure by attracting new customers over a period of time and accordingly it has capitalised the same under 'brand development expenses' and intends to amortise the same over the period in which it expects the benefits to flow. As the statutory auditor of the company, do you concur with this treatment? Give reasons.

(b) Dabloo Ltd. is facing financial crunch and has sold significant part of machinery to repay 25% amount of wages overdue. Many workers have also left the company due to non-payment of wages. Dabloo Ltd. is also considering filing for bankruptcy. The financial statements (and notes thereto) do not disclose the fact. As an Auditor, how would you deal with the situation? You are also required to identify the type of opinion you would issue and draft the same.

(c) OST Limited, a manufacturing company donated ₹ 45,000 and ₹ 55,000 to Charitable Societies namely 'Healthy World Charitable Foundation' and 'Learning Kids Foundation' respectively during the financial year 2015-16. The company has not taken any approval in general meeting for such donation. The average net profits of the company for the last three years were ₹ 15 lakhs. As an auditor, what will be your comment?

(d) As a Statutory Auditor, how would you report the following under CARO, 2015:

(i) A term loan was obtained from a bank for ₹ 110 lakh for acquiring R&D equipment, out of which ₹ 45 lakh was used to buy a car for use of the concerned director who was overlooking the R&D activities.

(ii) Physical verification of only 50% of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources.

Liabilities of Auditor

9. (a) In assessment procedure of ABC Ltd., Income Tax Officer observed some irregularities. Therefore, he started investigation of books of accounts audited and signed by Mr. X, a practicing Chartered Accountant. While going through books he found that ABC Ltd. used to maintain two sets of books of accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the Institute of Chartered Accountants of India saying Mr. X had negligently performed his duties. Comment.

(b) Briefly explain the criminal liabilities of an auditor under the Companies Act, 2013.

Audit Committee and Corporate Governance

10. The audit committee has been granted several roles under Clause 49 of the Listing Agreement. Oversight of the company's financial reporting process; recommendation for appointment of auditors; approval of payment to statutory auditors etc. are some of the roles that an audit committee perform. State the role of Audit Committee as provided under Clause 49 of the Listing Agreement.

Audit of Consolidated Financial Statements

11. (a) "Permanent Consolidation Adjustments are made only on the first occasion of the preparation and presentation of consolidated financial statements". What are the Permanent Consolidation Adjustments? Explain the role of auditor in this context.

    (b) While doing the audit of consolidated Financial Statements, which current period consolidation adjustments are to be taken into account?

Audit of Banks

12. (a) As a branch auditor of a Nationalised bank, how would you classify the following advances based on securities?

    (i) Advances covered by ECGC/DISGC guarantees.

    (ii) An account which is fully secured but the margin in which is lower than that stipulated by the bank.

    (iii) Advances covered against cheques purchased including self cheques.

    (iv) Advances against supply bill.

    (b) As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd., state the issues which have to be considered in the audit of advances.

Audit of General Insurance Companies and Co-operative Societies

13. (a) "In an audit of an insurance company, the Receipts and Payments Account is also subjected to audit". Comment.

    (b) Mention the duties of Auditor of Co-operative Societies in regard to the following:

    (i) Over-due interest.

    (ii) Compliance with provisions of Co-operative Act and Rules thereunder.

    (iii) Special Report to Registrar of Co-operative Societies.

Audit under Fiscal Laws

14. (a) XYZ Pvt. Ltd., a company in which public are not substantially interested, issued 1,00,000 equity shares at a premium of ₹ 70 per share (face value ₹ 10 per share). The fair market value of the shares as on the date of issue was ₹ 60 per share.

    As the tax auditor of XYZ Pvt. Ltd., how would you report the same in your tax audit report?

    (b) X Ltd. has sold one of its buildings situated in Kolkata during the year for a consideration of ₹ 40 lakh. However, the stamp duty value assessed by the authority of Government of West Bengal is ₹ 48 lakh.

    As a Tax auditor, what will be your reporting requirement? Will it make any difference, if value adopted is more than that as assessable by any Authority of a State Government?

(c) Draft an audit programme for conducting the audit of a Public Trust registered under section 12A of the Income-tax Act, 1961.

Cost Audit

15. (a) Expro Ltd. is engaged in the production of steel. A Chartered Accountant Firm 'M/s Manan & Co.' was appointed as the statutory auditor of Expro Ltd. for the current financial year. During the year, the management of the company realised that the company is required to maintain cost records in their books of account and get it audited. Therefore, in a general meeting, the members of the company appointed M/s Manan & Co. as the cost auditor of the company. You are required to examine the validity of appointment of M/s Manan & Co. as the cost auditor.

(b) "Like every other audit, a systematic planning for cost audit is also necessary". Indicate the matters to be included in a Cost Audit Programme.

Audit of Public Sector Undertakings

16. (a) Briefly explain performance audit? What are the considerations need to be taken care while performing such audit.

(b) Enumerate the right of C&AG of India to conduct a supplementary audit of the financial statement of a company, or comment upon or supplement audit report provided under section 143(6) of the Companies Act, 2013.

Internal Audit, Management and Operational Audit

17. (a) You have been appointed as management auditor of a large engineering company suffering from a working capital crunch. Enlist and discuss the related areas which you would probe into to overcome the company's problem.

(b) Amazekart, a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management.

Investigation and Due Diligence

18. (a) Mr. Manan is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. Preeto Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business. What procedures you would adopt before you could render any advice to Preeto Ltd.?

(b) Runri Ltd., a company engaged in manufacturing of chemicals is consistently recording higher sales turnover, but declining net profits since the last 5 years. As an investigator appointed to find out the reasons for the same, what are the points you would verify?

Professional Ethics

19. Comment on the following with reference to the Chartered Accountants Act, 1949, and Schedules thereto:

(a) CA. Arjit registered his proprietorship firm last year and started practicing in the name of "M/s Arjit & Co.". He is of the view that a professional need to maintain books of accounts only if his earnings exceed the minimum prescribed limit as per section 44AA of the Income Tax Act, 1961. Therefore, he decided not to maintain his books of accounts as his earnings are below the prescribed limit given under section 44AA of the said Act.

(b) CA. Sufi is practicing since 2008 in the field of company auditing. Due to his good practical knowledge, he was offered editorship of a 'Company Audit' Journal which he accepted. However, he did not take any permission from the council regarding such editorship.

(c) As a Chartered Accountant in practice, Mr. Denis is offered to conduct a review of the "Profit Forecast" prepared by a company in connection with its application for a term loan from a financial institution.

(d) CA. Sonu and CA. Monu are two partners of the CA firm 'Sonu Monu and Associates'. Being very pious, CA. Sonu organised a religious ceremony at his home for which he instructed his printing agent to add his designation "Chartered Accountant" with his name in the invitation cards. Later on, the invitations were distributed to all the relatives, close friends and clients of both the partners.

Other Miscellaneous Chapters

20. Write short notes on the following:

(a) Haphazard Sampling.

(b) Key functions of an Energy Auditor.

(c) Collection of Evidence by Peer Reviewer.

(d) Compliance of Prudential Norms of RBI by NBFC.

(e) Circumstances in which Chartered Accountant in practice or firm of Chartered Accountants cannot conduct Tax Audit u/s 44 AB of the Income Tax Act, 1961 of the concern.

SUGGESTED ANSWERS/HINTS

1. (a) **Procedures for Review of Financial Statements:** As per SRE 2400 "Engagements to Review Financial Statements", procedures for the review of financial statements will ordinarily include-

(i) Discuss terms and scope of the engagement with the client and the engagement team.

(ii) Prepare an engagement letter setting forth the terms and scope of the engagement.

(iii) Obtain an understanding of the entity's business activities and the system for recording financial information and preparing financial statements.

(iv) Inquire whether all financial information is recorded:

(a) Completely;

(b) Promptly; and

(c) After the necessary authorisation.

(v) Obtain the trial balance and determine whether it agrees with the general ledger and the financial statements.

(vi) Consider the results of previous audits and review engagements, including accounting adjustments required.

(vii) Inquire whether there have been any significant changes in the entity from the previous year (e.g., changes in ownership or changes in capital structure).

(viii) Inquire about the accounting policies and consider whether:

(a) They comply with the applicable accounting standards;

(b) They have been applied appropriately; and

(c) They have been applied consistently and, if not, consider whether disclosure has been made of any changes in the accounting policies.

(ix) Read the minutes of meetings of shareholders, the board of directors and other appropriate committees in order to identify matters that could be important to the review.

(x) Inquire if actions taken at shareholder, board of directors or comparable meetings that affect the financial statements have been appropriately reflected therein.

(xi) Inquire about the existence of transactions with related parties, how such transactions have been accounted for and whether related parties have been properly disclosed.

(xii) Inquire about contingencies and commitments.

(xiii) Inquire about plans to dispose of major assets or business segments.

(xiv) Obtain the financial statements and discuss them with management.

(xv) Consider the adequacy of disclosure in the financial statements and their suitability as to classification and presentation.

(xvi) Compare the results shown in the current period financial statements with those shown in financial statements for comparable prior periods and, if available, with budgets and forecasts.

(xvii) Obtain explanations from management for any unusual fluctuations or inconsistencies in the financial statements.

(xviii) Consider the effect of any unadjusted errors – individually and in aggregate.

Bring the errors to the attention of management and determine how the unadjusted errors will influence the report on the review.

(xix) Consider obtaining a representation letter from management.

(b) **Contrast of a Review Assignment with the Statutory Audit of the Company's Financial Statements with regard to the Scope of the Assignment and to the Report issued is hereunder:**

SCOPE	
Review assignment	**Statutory audit**
• Scope of Review assignments are generally falls in agreement between parties.	• Scope of Statutory audit should be in accordance with the Companies Act, 2013 or in accordance with other statute.
• Scope of Review assignments are restricted to instructions.	• Scope of Statutory audit should be in accordance with Audit Regulations and Norms.
• Review assignment should be done in accordance with SREs.	• Statutory audit should be conducted in accordance with Engagement and Quality Control Standards, Statements and Guidance Notes etc.
REPORT	
Review assignment	**Statutory audit**
• Report of Review assignment is addressed to the board.	• Statutory Audit Report is addressed to the members.
• Format of Report of Review assignment is wholly discretionary.	• Statutory Audit Report is on true and fair view and as per prescribed Format.
• Report of Review assignment is private report.	• Statutory Audit Reports are in public domain.

2. (a) **Understanding How User Entity Uses the Services of Service Organisation:** As per SA 402 on "Audit Considerations Relating to an Entity Using a Service Organisation", when obtaining an understanding of the user entity in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:

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

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

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

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

(b) Compliance with Other Laws: As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements including tax and labour laws.

Further, non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements.

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

If the auditor is precluded by management from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit.

In the instant case, major portion of the labour employed in the company was child labour. While questioning by auditor, reply of the management that it was outside his scope of financial audit to look into the compliance with other laws is not acceptable as it may have a material effect on financial statements.

Thus, auditor should ensure the disclosure of above fact and provision for the cost of fines, litigation or other consequences for the entity. In case, the auditor concludes that non-compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statement.

(c) Non-Chartered Accountant as Branch Auditor: As per section 143(8) of the Companies Act, 2013, where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company under this Act or by any other person qualified for appointment as an auditor of the company. Where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

Thus, a non- Chartered Accountant can be appointed as an auditor of branch office located outside India provided he is qualified for appointment as an auditor in that country.

Using the Work of Another Auditor: When the accounts of the branch are audited by a person other than the company's auditors, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of accounts of the branch and the audit of the company as a whole. Also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in SA 600, "Using the Work of another auditor". It makes clear that in certain situations, the statute governing the entity may confer the right on the principal auditor to visit a component and examine the books of accounts and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it necessary for him to visit the component and/or to examine the books of accounts and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditors' purpose, in context of the specific assignment.

3. (a) **The Internal Audit Programme in connection with Plant and Machinery, Tools and Dies may be on the following lines:**

(i) **Internal Control Aspects -** The following may be incorporated in the audit programme to check the internal control aspects:

(a) Maintaining separate register for hired assets, leased asset and jointly owned assets.

(b) Maintaining register of fixed asset and reconciling to physical inspection of fixed asset and to nominal ledger.

(c) All movements of assets are accurately recorded.

(d) Authorisation be obtained for –

(i) a declaring a fixed asset scrapped.

(ii) selling a fixed asset.

(e) Check whether additions to fixed asset register are verified and checked by authorised person.

(f) Proper recording of all additions and disposal.

(g) Examining procedure for the purchase of new fixed assets, including written authority, work order, voucher and other relevant evidence.

(h) Regular review of adequate security arrangements.

(i) Periodic inspection of assets is done or not.

(j) Regular review of insurance cover requirements over fixed assets.

(ii) Assets Register: To review the registers and records of plant, machinery, etc. showing clearly the date of purchase of assets, cost price, location, depreciation charged, etc.

(iii) Cost Report and Journal Register: To review the cost relating to each plant and machinery and to verify items which have been capitalised.

(iv) Code Register: To see that each item of plant and machinery has been given a distinct code number to facilitate identification and verify the maintenance of Code Register.

(v) Physical Verification: To see physical verification has been conducted at frequent intervals.

(vi) Movement Register: To verify (a) whether a Movement Register for movable equipments and (b) log books in case of vehicles, etc. are being maintained properly.

(vii) Assets Disposal Register: To review whether assets have been disposed off after proper technical and financial advice and sales/disposal/retirement, etc. of these assets are governed by authorisation, sales memos or other appropriate documents.

(viii) Spare Parts Register: To examine the maintenance of a separate register of tools, spare parts for each plant and machinery.

(ix) Review of Maintenance: To scrutinise the programme for an actual periodical servicing and overhauling of machines and to examine the extent of utilisation of maintenance department services.

(x) Review of Obsolescence: To scrutinise whether expert's opinion have been obtained from time to time to ensure purchase of technically most useful efficient and advanced machinery after a thorough study.

(xi) Review of R&D: To review R&D activity and ascertain the extent of its relevance to the operations of the organisation, maintenance of machinery efficiency and prevention of early obsolescence.

(b) Development of an Overall Plan: Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit-

(i) Terms of his engagement and any statutory responsibilities.

(ii) Nature and timing of reports or other communications.

(iii) Applicable Legal or Statutory requirements.

(iv) Accounting policies adopted by the clients and changes, if any, in those policies.

(v) The effects of new accounting and auditing pronouncement on the audit.

(vi) Identification of significant audit areas.

(vii) Setting of materiality levels for the audit purpose.

(viii) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.

(ix) Degree of reliance to be placed on the accounting system and internal control.

(x) Possible rotation of emphasis on specific audit areas.

(xi) Nature and extent of audit evidence to be obtained.

(xii) Work of the internal auditors and the extent of reliance on their work, if any in the audit.

(xiii) Involvement of other auditors in the audit of subsidiaries or branches of the client and involvement of experts.

(xiv) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.

(xv) Establishing and coordinating staffing requirements.

4. (a) **Control System over Selling and Collection of Tickets:** In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted -

(i) **Printing of tickets:** Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.

(ii) **Ticket sales:** The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.

(iii) **Daily cash reconciliation:** Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.

(iv) Daily banking: Each day's collection should be deposited in the bank on next working day of the bank. Till that time, the cash should be in the custody of properly authorized person preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.

(v) Entrance ticket: Entrance tickets should be cancelled at the entrance gate when public enters the centre.

(vi) Advance booking: If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.

(vii) Discounts and free pass: The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.

(viii) Surprise checks: Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

(b) Corporate Responsibility under Sarbanes-Oxley Act of 2002: The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. The act contains eleven titles and establishes corporate accountability and civil and criminal penalties for white – collar crimes. The title three deals with the Corporate Responsibility which is as follows-

(i) The audit committee to be more independent through enhancement of their over sight responsibilities and one of the Audit committee members to be financial expert.

(ii) Requires CEO& CFO to issue certification of the quarterly financial results and annual reports to SEC as part of compliance with Form 10K.

(iii) Provides rules of conduct for companies managerial and their officers regarding Pension matters.

(iv) To Comply with SEC rules requiring attorneys to report violation of securities to the company's CEO or Chief Legal Counsel and to Audit Committee if no action is taken.

5. (a) A key feature of the accounting software package used by the company definitely involves the absence of a clear audit trail. In other words, transactions cannot be easily traced or co-related from the individual supporting documents of those transactions. Moreover, the management does not wish to print the daybooks in view of the voluminous nature since it may involve extensive costs. This has naturally led to extensive dependence by management upon the "exception reporting" principle.

From the auditor's point of view, it must also be conceded, the exception reports in the form of 'query-based reports' which isolate the above data provide him with the very material that he requires for most of his verification work. The only problem which it raises, and it is a serious one, is that he cannot simply assume that the programmes which produce the exception reports are reliable in respect of the following factors:

(i) operating accurately;

(ii) printing out all the exceptions which exist; and

(iii) bound by programmed control parameters which meet the company's genuine internal control requirements.

In view of the above, whether management relies upon exception reports, it effectively eliminated the audit trail between input and output and the auditor is forced to test the invisible processes which purport to embody the controls, and produce the output such as it is. These tests, which invariably involve the use by the auditor of the computer itself, are known as tests through the machine. In the 'through the machine' approach, the auditor starts by proving the accuracy of the input data, and then thoroughly examines (by applying tests) the processing procedures with a view to establishing the following that:

(i) all input is actually entered into the computer.

(ii) neither the computer nor the operators can cause undetected irregularities in the final reports.

(iii) the programmes appear, on the evidence of rejection and exception routines, to be functioning correctly.

(iv) all operator intervention during processing is logged and scrutinised by the DP manager.

The auditor in such circumstances will have to first evaluate the existing controls. For the same, he has to do the following:

(i) Evaluate the internal control system especially the controls and checks existing for recording the transactions, i.e., he has to verify at what level transactions can be entered into the system and what checks are available to prevent any unauthorised data entry and for rectifying errors/omissions in the transactions entered.

(ii) Evaluate at what level there authority is given for modification of transactions already entered. Is there any authority given only to a senior employee to carry out modifications? Or is it that once transactions are entered and validated, no further modifications are possible thereto.

(iii) Whether there is a provision in the software for carrying out an on line audit of transactions, i.e. whether there a separate module in the package, where a separate password given to the auditor and once he has seen and approved a particular transaction/set of transactions, the same would be locked and no modifications would be possible by anyone (including the senior most employee) in the company.

(iv) Whether there are proper procedures for backup of data on a regular basis and whether the said procedures are being strictly followed.

(v) In case of any loss of data whether there is a clear defined recovery procedure to minimize the loss of data due to power failures or any human errors.

(vi) The auditor may introduce some dummy data into the system and see the results obtained.

After the auditor has evaluated the above procedures, he has to prepare an audit plan depending on the results obtained from his earlier evaluation. Since the daybooks are not being printed, the plan can contain procedures wherein data is verified directly on the computer from the vouchers/invoices, etc. The audit plan will also require a lot of analytical procedures to be performed. Depending on the importance of various expense heads and other important account heads, the auditor will also obtain various reports from the system depending on various queries that he would have to identify. Some illustrative reports can be:

(i) To check whether proper classification is done for revenue/capital - a report can be obtained of all purchases (not being raw materials or other routine purchases) exceeding ₹ 1 lakh.

(ii) To check whether all freight outward bills are accounted for a report containing a month-wise co-relation between goods despatched and freight amount paid. The same can be further co-related with the freight rates obtained from the bills.

Once the auditor has performed the above procedures, he would be able to form an opinion whether reliance can be placed on the accounting systems and the data recorded. If the auditor finds that reliance cannot be placed on the systems he can inform the management about the fact and also that the daybooks, etc., will need to printed to allow him to conduct the audit. The finalisation procedures to be followed even under this system would remain more or less similar to other accounting systems. The auditor can obtain reports of depreciation on fixed assets, inventory valuation and using the normal procedures find out whether reliance can be placed on them, e.g., if while valuing stocks the system is using the LIFO method, the same would not be acceptable and will need to be modified. Similarly depreciation calculations will have to verify on a random basis to find out its reliability.

(b) The reliability of a component is a function of control that acts on the component. In a computer system the following are the major types of controls and used to enhance component reliability which the auditor must evaluate:

(i) Authenticity Control: They are exercised to verify the identity of the individuals or process involved in a system. (Pass word, digital signature etc.)

(ii) Accuracy Control: These attempts to ensure the correctness of the data and processes in a system (Programme validation check).

(iii) **Completeness Control**: This ensures that no data is missing and all processing is carried through to its proper conclusion.

(iv) **Privacy Control**: This ensures the protection of data from inadvertent or unauthorised disclosure.

(v) **Audit Trail Controls**: This ensures the traceability of all events occurred in a system.

(vi) **Redundancy Control**: It ensures that processing of data is done only once.

(vii) **Existence Control**: It attempts to ensure the on going availability of all system resources.

(viii) **Asset safeguarding controls**: It attempts to ensure that all resources within a system are protected from destruction or corruption.

(ix) **Effectiveness Control**: It attempts to ensure that the system achieves its goals.

(x) **Efficiency Control**: It attempts to ensure that a system uses minimum resources to achieve its goals.

6. **Ceiling on Number of Audit:** As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.

As per section 141(3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

In the given case, CA. Satyam is holding appointment in 4 companies, whereas CA. Shivam is having appointment in 6 Companies and CA. Sundaram is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

(a) Therefore, M/s SSS & Co. can hold appointment as an auditor of 40 more companies:

Total Number of Audits available to the Firm	= 20*3	=	60
Number of Audits already taken by all the partners in their individual capacity	= 4+6+10	=	<u>20</u>
Remaining number of Audits available to the Firm		=	<u>40</u>

(b) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g) - already holding appointments as an auditor.

Hence (1) CA. Satyam can hold: 20 - 4 = 16 more audits. (2) CA. Shivam can hold 20 - 6 = 14 more audits and (3) CA. Sundaram can hold 20 -10 = 10 more audits.

(c) In view of above disussed provisions M/s SSS & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.

(d) As per fact of the case, M/s SSS & Co. is already having 20 company audits and they can also accept 40 more company audits. In addition, they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than ₹ 100 crores. In the given case, out of the 60 private companies, M/s SSS & Co. is offered 45 companies having paid-up share capital of ₹ 110 crore each.

Therefore, M/s SSS & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than ₹ 100 crore and 40 private companies having paid-up share capital of ₹ 110 crore each in addition to above 20 company audits already holding.

7. (a) **Audit Firm having Common Partner:** Section 139(2) of the Companies Act, 2013 provides that as on the date of appointment, no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years.

In the given case, CA. Rock is a common partner in M/s Ajay & Associates and M/s Vijay & Associates. The tenure of 10 years of M/s Ajay & Associates as an auditor has been expired in Sanjay Ltd. immediately preceding the current financial year i.e. the firm shall not be eligible for re-appointment as auditor in the same company for 5 years from the completion of such term.

Therefore, M/s Vijay & Associates will also be disqualified to be appointed as auditor of Sanjay Ltd. for next 5 financial years as CA. Rock was the common partner of M/s Vijay & Associates whose tenure in Sanjay Ltd. has expired.

(b) **Retiring Partner being In-charge in Previous Audit Firm:** As per 139(2) of the Companies Act, 2013 read with the explanation given under Companies (Audit and Auditors) Rules, 2014 for the purpose of rotation of auditors, if a partner, who is in-charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of 5 years.

In the given case, CA. Rock was in-charge of M/s Ajay & Associates and certifying authority of financial statements of Sanjay Ltd. who retires from the said firm and joins M/s Vijay & Associates. The tenure of 10 years of M/s Ajay & Associates as an auditor has been expired in Sanjay Ltd. immediately preceding the current financial year i.e. the firm shall not be eligible for re-appointment as auditor in the same company for 5 years from the completion of such term.

Therefore, M/s Vijay & Associates will also be disqualified to be appointed as auditor of Sanjay Ltd. for next 5 financial years as newly joined partner CA. Rock has retired from M/s Ajay & Associates immediately preceding the current financial year whose tenure in Sanjay Ltd. has expired.

8. (a) Capitalisation of Expenses: As per Accounting Standard 26 on "Intangible Assets", expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria.

In the given case, FX Ltd. incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefits by this expenditure by attracting new customers over a period of time and accordingly it has capitalised the same under brand development expenses. Here, no intangible assets or other asset is acquired or created that can be recognised.

Therefore, the accounting treatment by the company to amortise the entire expenditure over the period in which it expects the benefits to flow is not correct and the same should be debited to the Statement of Profit and Loss in the year of incurring.

(b) Disclosure for Uncertainty about Going Concern: As per SA 570 "Going Concern", it is the responsibility of the Auditor to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

In the given case, Dabloo Ltd. has sold significant part of machinery to repay its wages overdue and also 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 would be unable to realize its assets and discharge its liabilities in the normal course of business.

Thus, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified or adverse opinion. In view of circumstances mentioned in SA 705 "Modifications to the Opinion in the Independent Auditor's Report", the auditor should give adverse opinion in above case as follows -

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give 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:

(i) In the case of the Balance sheet, of the state of affairs of the Company as at March 31,20xx;

(ii) In the case of the Profit & Loss account, of the profit/loss for the year ended on that date; and

(iii) In the case of the Cash flow statement, of the cash flow for the year ended on that date.

(c) Donation to Charitable Institutions*:* Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to bona fide charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed 5 per cent of its average net profits for the three immediately preceding financial years.

In the instant case, OST Limited has given donation of ₹ 1,00,000/- (₹ 45,000/- + ₹ 55,000/-) to two charitable organisations. The average profit of the last 3 years is ₹ 15 lakhs and the 5% of this works out to ₹ 75,000. Hence the maximum of donation could be ₹ 75,000 only. For excess of ₹ 25,000 the company is required to take prior permission in general meeting which is not been taken.

Therefore, by paying donations of ₹ 1,00,000 which is more than ₹ 75,000, the Board has contravened the provisions of section 181 of the Companies Act, 2013. Hence, the auditor should qualify his report accordingly.

(d) Reporting under CARO, 2015

(i) Utilisation of Term Loans: According to clause (xi) of Para 3 of CARO, 2015, the auditor is required to comment whether term loans were applied for the purpose for which the loans were obtained.

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, term loan taken for the purpose of R&D equipment has been utilized for the purchase of car which has no relation with R&D equipment.

Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report that out of the term loan taken for R&D equipment, ₹ 45 lakh was not utilised for the purpose of acquiring R&D equipment.

(ii) Physical Verification of Inventory: Clause (ii) of Para 3 of CARO, 2015 requires the auditor to report on whether physical verification of inventory has been conducted at reasonable intervals by the management. Physical verification of inventory is the responsibility of the management which should verify all material items at least once in a year and more often in appropriate cases. The auditor in order to satisfy himself about verification at reasonable intervals should examine the adequacy of evidence and record of verification.

In the given case, the above requirement of CARO, 2015 has not been fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on financial statement and report accordingly.

9. (a) **Liability of Auditor:** It is the auditor's responsibility to audit the statement of accounts and prepare tax returns on the basis of books of accounts produced before him. Also if he is satisfied with the books and documents produced to him, he can give his opinion on the basis of those documents only by exercising requisite skill and care and observing the laid down audit procedure.

In the instant case, Income tax Officer observed some irregularities during the assessment proceeding of ABC Ltd. Therefore he started investigation of books of accounts audited and signed by Mr. X, a practicing Chartered Accountant. While going through the books, he found that ABC Ltd. used to maintain two sets of books of accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the ICAI saying Mr. X had negligently performed his duties.

Mr. X, the auditor was not under a duty to prepare books of accounts of assessee and he should, of course, neither suggest nor assist in the preparations of false accounts. He is responsible for the books produced before him for audit. He completed his audit work with official set of books only.

In this situation, as Mr. X, performed the auditing with due skill and diligence, therefore, no question of negligence arises. It is the duty of the Department to himself investigate the truth and correctness of the accounts of the assessee.

(b) **Criminal Liability of an Auditor under the Companies Act**, 2013: The circumstances in which an auditor can be prosecuted under the Companies Act and the penalties to which he may be subjected are briefly stated below-

(i) **Criminal liability for Misstatement in Prospectus -** As per Section 34 of the Companies Act, 2013, where a prospectus, issued, circulated or distributed includes any statement which is untrue or misleading in form or context in which it is included or where any inclusion or omission of any matter is likely to mislead, every person who authorises the issue of such prospectus shall be liable under section 447.

This section shall not apply to a person if he proves that such statement or omission was immaterial or that he had reasonable grounds to believe, and did up to the time of issue of the prospectus believe, that the statement was true or the inclusion or omission was necessary.

(ii) **Punishment for False Statement -** According to Section 448 of the Companies Act, 2013, if in any return, report, certificate, financial statement, prospectus, statement or other document required by, or for, the purposes of any of the provisions of this Act or the rules made thereunder, any person makes a statement-

(1) which is false in any material particulars, knowing it to be false; or

(2) which omits any material fact, knowing it to be material,

he shall be liable under section 447.

Punishment for Fraud - As per Section 447 of the Companies Act, 2013, without prejudice to any liability including repayment of any debt under this Act or any other law for the time being in force, any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than 6 months but which may extend to 10 years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

It may be noted that where the fraud in question involves public interest, the term of imprisonment shall not be less than 3 years.

Explanation — For the purposes of this section—

(i) "fraud" in relation to affairs of a company or any body corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;

(ii) "wrongful gain" means the gain by unlawful means of property to which the person gaining is not legally entitled;

(iii) "wrongful loss" means the loss by unlawful means of property to which the person losing is legally entitled.

10. Role of Audit Committee: The role of the audit committee as provided under Clause 49 shall include the following -

(i) Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible;

(ii) Recommendation for appointment, remuneration and terms of appointment of auditors of the company;

(iii) Approval of payment to statutory auditors for any other services rendered by the statutory auditors;

(iv) Reviewing, with the management, the annual financial statements and auditor's report thereon before submission to the board for approval, with particular reference to:

(a) Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (c) of sub-section 3 of section 134 of the Companies Act, 2013.

(b) Changes, if any, in accounting policies and practices and reasons for the same.

(c) Major accounting entries involving estimates based on the exercise of judgment by management.

(d) Significant adjustments made in the financial statements arising out of audit findings.

(e) Compliance with listing and other legal requirements relating to financial statements.

(f) Disclosure of any related party transactions.

(g) Qualifications in the draft audit report.

(v) Reviewing, with the management, the quarterly financial statements before submission to the board for approval;

(vi) Reviewing, with the management, the statement of uses/application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and the report submitted by the monitoring agency monitoring the utilisation of proceeds of a public or rights issue, and making appropriate recommendations to the Board to take up steps in this matter;

(vii) Review and monitor the auditor's independence and performance, and effectiveness of audit process;

(viii) Approval or any subsequent modification of transactions of the company with related parties;

(ix) Scrutiny of inter-corporate loans and investments;

(x) Valuation of undertakings or assets of the company, wherever it is necessary;

(xi) Evaluation of internal financial controls and risk management systems;

(xii) Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems;

(xiii) Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit;

(xiv) Discussion with internal auditors of any significant findings and follow up there on;

(xv) Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board;

(xvi) Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern;

(xvii) To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non-payment of declared dividends) and creditors;

(xviii) To review the functioning of the Whistle Blower mechanism;

(xix) Approval of appointment of CFO (i.e., the whole-time Finance Director or any other person heading the finance function or discharging that function) after assessing the qualifications, experience and background, etc. of the candidate;

(xx) Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

It is important to note that the term "related party transactions" shall have the same meaning as provided in Clause 49(VII) of the Listing Agreement.

If the company has set up an audit committee as per section 177 of the Companies Act, the company agrees that the said audit committee shall have such additional functions / features as is contained in the Listing Agreement.

11. (a) **Permanent Consolidation Adjustments:** Permanent consolidation adjustments are those adjustments that are made only on the first occasion of the preparation and presentation of consolidated financial statements. Permanent consolidation adjustments are-

(i) determination of excess or deficit of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made (determination of goodwill or capital reserve);

(ii) determination of the amount of equity attributable to minorities at the date on which investment in subsidiary is made; and

(iii) determination of goodwill or capital reserve arising on application of equity method to account for investments in associates in consolidated financial statements.

Role of Auditor – Verification Procedure:

(i) The auditor should verify that the above calculations have been made appropriately.

(ii) The auditor should pay particular attention to the determination of pre-acquisition reserves of the subsidiary and associates. Date(s) of investment in subsidiary and associates assumes importance in this regard.

(iii) The auditor should also examine whether the pre-acquisition reserves have been allocated appropriately between the parent and the minorities of the subsidiary.

(iv) The auditor should also verify the changes that might have taken place in these permanent adjustments on account of subsequent acquisition of shares in the subsidiary/ associates, disposal of the subsidiary/associate in the subsequent years.

(v) The auditor should also examine the joint venture agreements, to establish whether any change has taken place in the interest of the parent in the joint venture.

(vi) It may happen that in the case of one subsidiary, goodwill arises and in the case of another subsidiary a capital reserve arises. The parent may choose to net off these amounts to disclose a single amount in the consolidated balance sheet. In such cases, the auditor should verify that the gross amounts of goodwill and capital reserves arising on acquisition of various subsidiaries have been disclosed in the notes to the consolidated financial statements to reflect the excess/shortage over the parents' portion of the subsidiary's equity.

(b) Following are the Current Period Consolidation Adjustments while making Consolidation of Financial Statements:

(i) Elimination of intra-group transactions relating to interest or management fees etc.

(ii) Elimination of unrealized intra-group profits on assets acquired from other subsidiaries.

(iii) Elimination of intra-group indebtedness.

(iv) Adjustments for harmonizing different accounting policies of parent unit and its subsidiaries.

(v) Adjustments for impairment loss that might exist for goodwill.

(vi) Adjustment for significant events that occur between date of financial statements of the parent and of its components when the date/s of financial statements of components are different from the reporting date.

(vii) Determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.

(viii) Treatment of minority interests' share of the losses, if such losses exceed the minority interests' share in the equity.

12. (a) Classification of Advances of a Bank based on Security:

(i) Advances covered by ECGC/DICGC guarantee should be treated as covered by guarantee to the extent of guarantee cover available. The amount received from ECGC/DICGC and kept in sundry creditor account pending adjustment should be deducted from advances.

(ii) An account which is fully secured but the margin in which is lower than stipulated by the bank should nevertheless be treated as fully secured for the purpose of balance sheet presentation.

(iii) Cheques purchased including self cheques should be treated as unsecured.

(iv) Advances against supply bill unless collaterally secured, should be classified as unsecured even if they have been accepted by the drawee.

(b) Audit of Advances: The items to be covered in the current audit of advances of a bank are as follows-

(i) Ensure that loans and advances are sanctioned properly.

(ii) Verify whether the sanctions are in accordance with the delegated authority.

(iii) Ensure that securities and documents have been received and properly charged/registered.

(iv) Ensure that post disbursement supervision and follow up is proper.

(v) Verify whether there is any misuse of loans and advances and whether there are instances indicative of diversion of funds.

(vi) Check whether letters of credit issued by the branch are within the delegated power and ensure that they are genuine trade transactions.

(vii) Check bank guarantees issued are properly worked and recorded.

(viii) Ensure proper follow up of overdue bills of exchange.

(ix) Verify the classifications of advances are as per RBI directions.

(x) Verify whether the submission of claims to DICGC and ECGC is in time.

(xi) Verify the instances of exceeding delegated powers have been promptly reported.

(xii) Verify the frequency and genuiness of such exercise of authority beyond to delegated powers of the concerned officials.

13. (a) Audit of Receipts and Payments Account: Every insurer, in respect of insurance business transacted by him and in respect of his shareholders' funds, should prepare at the end of each financial year, a Balance Sheet, a Profit and Loss Account, a separate account of receipts and payments and a Revenue Account in accordance with the Regulations made by the IRDA. Since receipts and payments account has been made a part of financial statements of an insurer, it is implied that the receipts and payments account is also required to be audited.

The IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations require that the auditor of an insurance company should:

(i) report whether the receipts and payments account of the insurer is in agreement with the books of account and returns;

(ii) express an opinion as to whether the receipts and payments account has been prepared in accordance with the provisions of the relevant statutes; and

(iii) express an opinion whether the receipts and payments account give a true and fair view of the receipts and payments of the insurer for the financial year/period under audit.

It may hence be said that auditor is required to audit the Receipts and Payments Account of the insurer and also express an opinion on the same.

(b) (i) Overdue interest: Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.

(ii) Compliance with provisions of the Act and Rules: An auditor of a co-operative society is required to point out the infringement with the provisions of the relevant Co-operative Act Rules and bye-laws. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departure from the provision of the Act, rules framed thereunder and the bye-laws of the society. The financial implications of such infringements should be properly assessed and quantified by the auditor and they should be reported. Some of the State laws contain restrictions on the payment of dividends, which should be noted by the auditor and if dividend is declared in excess of the prescribed percentage, the fact should be reported by the auditor. Auditor should also ensure that various provisions in the Co-operative Societies Act, such as, restriction on borrowings, investment of funds, contribution to education funds, restriction on loans, etc are also complied with.

(iii) Special Report to the Registrar: The auditors are required to report on number of matters as prescribed in various states. In addition to the main report, the auditors are also required to submit by way of schedules/audit memorandum information on the working of the company as well. During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance a special report may become necessary:

(a) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.

(b) Detection of fraud relating to expenses, purchases, property and stores of the society.

(c) Specific examples of mis-management. Decisions of management against co-operative principles.

(d) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

14. (a) **Reporting for Issue of Shares for Value Exceeding Fair Market Value**: In this case, XYZ Pvt. Ltd. is a company, other than a company in which the public are substantially interested. It has received consideration for issue of shares of ₹ 80 per share (Face value ₹ 10 per share + Premium ₹ 70 per share) which exceeds the face value of ₹ 10 per share and fair market value of the shares of ₹ 60 per share.

Provisions and Explanations: A tax auditor has to furnish the details of shares issued during the previous year, under clause 29 of Form 3CD, in case, the assessee received any consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib) of the Income Tax Act, 1961.

Section 56(2)(viib) provides that where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be chargeable to income-tax under the head "Income from other sources".

Since section 56(2)(viib) is applicable to companies in which public is not substantially interested, reporting under this clause is to be done only for corporate assessees. The auditor should obtain from the auditee, a list containing the details of shares issued, if any, by him to any person being a resident and verify the same from the books of accounts and other relevant documents.

Conclusion: As per the facts of the case, provisions and explanations given above, the income generated by XYZ Pvt. Ltd., due to differences in consideration received and fair market value of shares issued, is chargeable to income-tax under the head "Income from other sources" as per section 56(2)(viib) of the Income Tax Act, 1961.

Therefore, the tax auditor of XYZ Pvt. Ltd. is required to furnish the details of shares issued under clause 29 of Form 3CD.

(b) **Reporting for Sale of Building for Value Less Than Adopted by Authority:** In this case, X Ltd. has sold one of its buildings situated in Kolkata for a consideration of ₹ 40 Lakh which is less than the value assessed by the Government of West Bengal i.e. Stamp Duty value of ₹ 48 Lakh.

Provisions and Explanations: As per Clause (17) of Form 3CD, the tax auditor is required to furnish detailed information in case if any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C of the Income-tax Act, 1961, as under:

Details of property	Consideration received or accrued	Value adopted or assessed or assessable

The auditor should obtain a list of all properties transferred by the assessee during the previous year. He may also verify the same from the statement of profit and loss or balance sheet, as the case may be. Further, the auditor has to furnish the amount of consideration received or accrued, during the relevant previous year of audit, in respect of land/building transferred during the year as disclosed in the books of account of the assessee.

For reporting the value adopted or assessed or assessable, the auditor should obtain from the assessee a copy of the registered sale deed in case, the property is registered. In case the property is not registered, the auditor may verify relevant documents from relevant authorities or obtain third party expert like lawyer, solicitor representation to satisfy the compliance of section 43CA / section 50C of the said Act. In exceptional cases where the auditor is not able to obtain relevant documents, he may state the same through an observation in his report 3CA/CB.

Conclusion: As discussed in fact of the cases, X ltd. has sold a building for an amount which is less than the stamp duty value. Hence, the tax auditor is required to report the details of property, consideration received or accrued and valued adopted or assessed or assessable under Clause (17) of Form 3CD.

Further, if value adopted is more than that assessable by any authority of State Government, no reporting is required by Tax Auditor.

(c) Audit Programme for Conducting Audit of Public Trust: An auditor should conduct routine checking during the course of audit of a public trust, in the following manner -

(i) Check the books of account and other records having regard to the system of accounting and internal control;

(ii) Vouch the transactions of the trust to satisfy that:

(1) the transaction falls within the ambit of the trust

(2) the transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;

(3) all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;

(4) all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust;

(5) amounts shown as applied towards the object of the trust are covered by the objects of trust as specified in the document governing the trust.

(iii) Obtain trial balance on the closing date certified by the trustees' duly certified by the trustee;

(iv) Obtain Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

15. (a) **Qualification and Appointment of Cost Auditor:** According to section 148(3) of the Companies Act, 2013 read with Companies (Audit & Auditors) Rules, 2014 -

(i) in the case of companies which are required to constitute an audit committee, the Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee;

(ii) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor.

It is also provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

In the given case, the members of Expro Ltd. appointed M/s Manan & Co., a practicing Chartered Accountant Firm and the statutory auditor of the company, as the cost auditor.

Therefore, the appointment of the CA firm as cost auditor made by the company is not valid. The Board shall appoint a cost accountant in practice or a firm of cost accountants in practice to conduct such cost audit.

(b) **Matters to be included in Cost Audit Programme:** It is a true statement that like any other audit a systematic planning for cost audit is also necessary. Therefore, the cost audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. This would require that the various aspects like what to be done, when to be done and by whom to be dome are adequately takes care of. However, looking to the basic difference in cost audit and financial audit as allocation and apportionment of expenses, statutory requirement etc. should require special consideration. Cost audit, in order to be effective, should be completed at one time as far as practicable. Based on above factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Matters to be included in the Cost Audit Programme may be divided into following two stages-

(I) **Review of Cost accounting record:** This will include -

(i) Method of costing in use - batch, process or unit.

(ii) Method of accounting for raw materials; stores and spares, wastages, spoilage defectives, etc.

(iii) System of recording wages, salaries, overtime and spares, wastages, etc.

(iv) Basis of allocation of overheads to cost centres and of absorption by products and apportionment of service department's expenses.

(v) Treatment of interest, recording of royalties, research and development expenses, etc.

(vi) Method of accounting of depreciation.

(vii) Method of stock-taking and its valuation including inventory policies.

(viii) System of budgetary control.

(ix) System of internal auditing.

(II) **Verification of cost statement and other data**: This will mainly cover-

(i) Licensed, installed and utilised capacities.

(ii) Financial ratios.

(iii) Production data.

(iv) Cost of raw material consumed, wages and salaries, stores, power and fuel, overheads provision for depreciation etc.

(v) Sales realisation.

(vi) Abnormal non-recurring and special costs.

(vii) Cost statements.

(viii) Reconciliation with financial books.

Some other factors which need to be brought into cost audit programme includes system of cost accounting, range of products, areas to be covered etc. indicating allocation of manpower and the time to be taken for computing the audit.

16. (a) **Performance Audit:** A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action. Performance audits include economy and efficiency; and program audits.

Economy and efficiency audits may, for example, consider whether the entity -

(i) is following sound procurement practices;

(ii) is acquiring the appropriate type, quality, and amount of resources at an appropriate cost;

(iii) is properly protecting and maintaining its resources;

(iv) is avoiding duplication of effort by employees and work that serves little or no purpose;

(v) is avoiding idleness and overstaffing;

(vi) is using efficient operating procedures;

(vii) is using the optimum amount of resources (staff, equipment, and facilities) in producing or delivering the appropriate quantity and quality of goods or services in a timely manner;

(viii) is complying with requirements of laws and regulations that could significantly affect the acquisition, protection, and use of the entity's resources;

(ix) has an adequate management control system for measuring, reporting, and monitoring a program's economy and efficiency; and

(x) has reported measures of economy and efficiency that are valid and reliable.

Program audits may, for example -

(i) assess whether the objectives of a new, or ongoing program are proper, suitable, or relevant;

(ii) determine the extent to which a program achieves a desired level of program results;

(iii) assess the effectiveness of the program and/or of individual program components;

(iv) identify factors inhibiting satisfactory performance;

(v) determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;

(vi) determine whether the program complements, duplicates, overlaps, or conflicts with other related programs;

(vii) identify ways of making programs work better;

(viii) assess compliance with laws and regulations applicable to the program;

(ix) assess the adequacy of the management control system for measuring, reporting, and monitoring program's effectiveness; and

(x) determine whether management has reported measures of program effectiveness that are valid and reliable.

(b) Right of C&AG of India under section 143(6) of the Companies Act, 2013: According to section 143(6) of the Companies Act, 2013, the Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report have a right to,

(i) conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and

(ii) comment upon or supplement such audit report.

It may be noted that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

17. (a) Action Plan to Overcome Working Capital Crunch: Adequate working capital is required for liquidity and smooth operations of the company. To ensure an adequate flow of working capital to the manufacturing company, the following action plan may be considered -

(i) Working Capital Estimation: The company should start by preparing a statement of the projected working capital requirements. This should be based on the functional budgets in sales, production, expenses, capital expenditure and the Master Budget consisting of projected profit and loss and the Balance Sheet.

(ii) Cash Flow Statement / Cash Budget: Month-wise cash budgets showing inflows and outflows of cash heading-wise should be prepared to analyse the major inflows and outflows affecting the entity. At this stage any wasteful outflow can be traced and eliminated. Bank reconciliation should be undertaken periodically so that outstandings can be traced and acted upon. This is also necessary to reduce the float time.

(iii) Inventory / Stock Management: Raw materials and inventories should be classified properly to determine the level of stock of materials. The method of costing also needs to be looked at minutely. There is a need to establish linkage with the production pattern and work backwards accounting for time factor in receipt of material. This needs to be worked out carefully since at no cost, production schedule should be hampered. The caution also need to be exercised that there is not unused/obsolete inventory. The system of inventory management needs to be looked at so as to check the avoidable wastes/scraps generated during storage and handling. Just in time philosophy will enable the company to reduce processing time, stocks and related costs. The adoption of such a mechanism would bring down the cost to a considerable extent.

(iv) Credit Management: The company should lay down a proper policy for evaluating customers, determining the credit period and offering discounts for early payment. An age-wise analysis of debtors should also be prepared so as to avoid credit to defaulters. The sale department needs to be geared up so that realisation can be made in time. A careful analysis should be done of various customers according to pattern of sales so as to exercise control on their respective debit balances. The company should through its purchase department endeavour to avail the maximum credit period from its creditors. This would enhance the working capital of the company.

(v) Funds Flow Analysis: The company should prepare a funds flow analysis, distinguishing between long-term and short-term sources and applications.

(vi) **Investment Management:** The idle funds of the company, if any, should be invested in short-term securities to augment the income.

(vii) **WIP Analysis:** Minimum WIP should be monitored and for the purpose it is necessary to ensure that no bottlenecks develop at any stage during the production process.

(b) **Alternative Way to Tackle the Hostile Management**: While conducting the operational audit, the auditor has to come across many irregularities and areas where improvement can be made and therefore he gives his suggestions and recommendations.

These suggestions and recommendations for improvements may not be accepted by the hostile managers and in effect there may be cold war between the operational auditor and the managers. This would defeat the very purpose of the operational audit.

The Participative Approach comes to the help of the auditor. In this approach the auditor discuses the ideas for improvements with those managers that have to implement them and make them feel that they have participated in the recommendations made for improvements. By soliciting the views of the operating personnel, the operational audit becomes co-operative enterprise.

This participative approach encourages the auditee to develop a friendly attitude towards the auditors and look forward to their guidance in a more receptive fashion. When participative method is adopted then the resistance to change becomes minimal, feelings of hostility disappear and gives room for feelings of mutual trust. Team spirit is developed. The auditors and the auditee together try to achieve the common goal. The proposed recommendations are discussed with the auditee and modifications as may be agreed upon are incorporated in the operational audit report. With this attitude of the auditor it becomes absolutely easy to implement the proposed suggestions as the auditee themselves take initiative for implementing and the auditor do not have to force any change on the auditee.

Hence, Operational Auditor of Amazekart manufacturing unit should adopt above mentioned participative approach to tackle the hostile management of Amazekart.

18. (a) **Due Diligence:** A due diligence audit on behalf of Preeto Ltd. with a view to acquiring the business shall involve following steps -

(i) **Brief history of the target and background of its promoters -** The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters have to be gone into, before verification of financial data in detail. An eye into the history of the target may reveal its turning points, survival strategies adopted by the target from time to time, the market share enjoyed by the target and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the target. Broadly, the accountant should make relevant enquiries about the history of target's business products, markets, suppliers, expenses, operations.

(ii) Accounting policies - The accountant should study the accounting policies being followed by the target and ascertain whether any accounting policy is inappropriate. The accountant should also see the effects of the recent changes in the accounting policies. The target might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale. The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should mainly look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target are different from those adopted by the acquiring enterprise, the effect of such differences.

(iii) Review of Financial Statements - Before commencing the review of each of the aspect covered by the financial statements, the accountant should examine whether the financial statements of the target have been prepared in accordance with the Statute governing the target, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards. If not the accountant should record the deviations from the above and consider whether it warrant an inclusion in the final report on due diligence.

After having an overall view of the financial statements, as mentioned in the above paragraphs, the accountant should review the operating results of the target in great detail. It is important to make an evaluation of the profit reported by the target. The reason being the price of the target would be largely based upon its operating results. The accountant should consider the presence of an extraordinary item of income or expense that might have affected the operating results of the target. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period.

(iv) Taxation - Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. Generally taxes are levied both by the Central Government as well as by the State Government. Further taxes may be direct or indirect. Most of the tax laws require the enterprise to register itself with the government and it is important to check if all necessary registrations have been made. The accountant has to also look at the tax effects of the merger or acquisition.

(v) Cash Flow - A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time. It is necessary to check if a) Is the company able to honour its commitments to its creditors, to the banks, to government and other stakeholders b) How well is the company able to turn its debtors and stocks c) How well does it deploy its funds d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(vi) Financial Projections - The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask to give projections on optimistic, pessimistic and most likely bases.

Ordinarily, it would be desirable that the accountant evaluates the appropriateness of assumption used in the preparation and presentation of financial projections. If, the accountant is of the opinion that as assumption used by the target is unrealistic, the accountant should consider its impact on the overall valuation of the company. He should offer his comments on all the assumption, highlighting those which, in his opinion are not inappropriate. In case he feels the projections provided by the target are not achievable or aggressive he has to mention this in his report. He should thoroughly check the arithmetic of the calculations made for financial projections.

(vii) Management and Employees - In the Indian context, the status of work force, staff and employees and their demands is a complex problem. In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. Due to complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce and it is important to gauge the likely impact of such litigation.

It is important to see if all employee benefits like Provident Fund (P.F.), Employees State Insurance (E.S.I), Gratuity, leave and Superannuation have been properly paid/ provided for/funded. In case of un-funded Gratuity, an actuarial valuation of the liability has to be obtained from a reputed actuary. The assumptions regarding increase in salaries, interest rate, retirement etc. have to be gone into to see if they are reasonable. It is also necessary to see if the basic salary /wage considered for the valuation is correct and includes all elements subject to payment of Gratuity. In the case of PF, ESI etc. the accountant has to see if all eligible employees have been covered.

It is very important to consider the pay packages of the key employees as this can be a crucial factor in future costs. One has to carefully look at Employees Stock Option Plans; deferred compensation plans; Economic Value Addition and other performance linked pay; sales incentives that have been promised etc. It is also important to identify the key employees who will not continue after the acquisition either because they are not willing to continue or because they are to be transferred to another company within the 'group' of the target company.

(viii) Statutory Compliance - During a due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

In addition to the above steps, the following further points have to be seen:

(i) Reason for sale of business and the effect on turnover and profits due to the exist of the present proprietor.

(ii) The length of the lease under which business has been operating.

(iii) The unexpired period of patents if any held by the vendors.

(iv) The age of managerial staff and prospects of their continuing in service in the new environment; the effect of trained managerial staff learning the organisation in production/sales/administrative and the financial liability to pay terminal benefits/compensation, etc.

(v) If bulk sales are to a few limited customers, the profitability should be discounted greatly, because any substantial withdrawal of customers might cause business crashes.

(vi) A company with a sound financial structure can better withstand the stresses and strains of business. A low debt-equity ratio would indicate an ability to grow through debt financing without raising equity.

(vii) The cash generated from operations; the need for redeployment of resources and funds needed for repayment of loans become major factors in determining growth potential.

(viii) The valuation of goodwill if any should be on reasonable basis having regards to all factors mentioned above.

(b) Investigation for Higher Sales Turnover: As per the facts that there has been consistently high turnover but declining net profits is an anomalous situation. It may be attributed to one or more following reasons requiring further investigation -

(i) Unfavourable Sales mix - Where the company sells different chemical products with different product margins, the product with the maximum PV ratio/margin should have a higher share in the total sales. If due to revision of sales mix, more quantities of unprofitable products are sold, profits will be reduced in spite of an increase in sales.

(ii) Negative Impact of Financial Leverage - Where the company does not have sufficient own funds (equity) but has a higher debt-equity ratio, the interest commitments will be higher. As the volume of its operation increases, higher debt and interest charges would result in lower profits.

(iii) Other Items Included in Sales - The figure of sales as per Profit and Loss Account may include incidental revenues, e.g., freight, excise duty, sales-tax, etc. where the amount of excise duty goes up considerably the total sales may show an increase which is not represented by a real increase in sales quantity/value.

(iv) High Administrative and Selling Expenses - Administrative and selling costs are generally period costs which are fixed in nature. Their increase is generally not proportional to sale increase. However, a reduction in profit could also be due to increase in administrative overheads and sales overheads at a rate higher than the rate of increase in sales.

(v) Cost-Price Relationship - If the increases in cost of raw materials and labour has not been compensated by a corresponding increase in the sales price this would also result in higher sales and declining profits. In spite of same sales quantity, for the increasing cost of raw materials and other services, per unit values of the product has been increased which is however unmatched by the increase in cost.

(vi) Competitive Price - Where sales have been made at cut-throat prices in order to eliminate competition from the market, the profits would be in the declining trend in the short-run.

(vii) Additions to Fixed Assets - Where there are heavy additions to fixed assets and consequent depreciation charges in the initial years of additions, there may be reduction in profits in spite of increased sales.

19. (a) Maintenance of Books of Accounts: Chapter V of the Council General Guidelines, 2008 specifies that a member of the Institute in practice or the firm of Chartered Accountants of which he is a partner shall maintain and keep in respect of his/its professional practice, proper books of accounts including the following:

(i) a Cash Book

(ii) a Ledger

Thus, a Chartered Accountant in practice is required to maintain books of accounts. In the instant case, CA. Arjit does not maintain books of accounts bearing in mind the provisions of section 44AA of the Income Tax Act, 1961.

Accordingly, it does not matter whether section 44AA of the Income Tax Act, 1961 applies or not. Hence, Mr. Arjit, being a practicing Chartered Accountant will be held guilty of professional misconduct for violation of Council General Guidelines, 2008.

(b) Permission from the Council: As per Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

However, the Council has granted general permission to the members to engage in certain specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In the instant case, CA. Sufi accepted editorship of a journal for which he did not take any permission from the Council. In this context, it may be noted that the editorship of professional journals is covered under the general permission.

Therefore, CA. Sufi shall not be held guilty of professional misconduct in terms of Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(c) **Certification of Financial Forecast:** Under Clause (3) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast.

Further, SAE 3400 "The Examination of Prospective Financial Information", provides that the management is responsible for the preparation and presentation of the prospective financial information, including the identification and disclosure of the sources of information, the basis of forecasts and the underlying assumptions. The auditor may be asked to examine and report on the prospective financial information to enhance its credibility, whether it is intended for use by third parties or for internal purposes. Thus, while making report on projection, the auditor need to mention that his responsibility is to examine the evidence supporting the assumptions and other information in the prospective financial information, his responsibility does not include verification of the accuracy of the projections, therefore, he does not vouch for the accuracy of the same.

Hence, Mr. Denis may accept the offer if the above requirements are complied with.

(d) **Printing of Designation "Chartered Accountant" on Invitations for Religious Ceremony:** As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

However, the Council of the ICAI is of the view that the designation "Chartered Accountant" as well as the name of the firm may be used in greeting cards, invitations for marriages, religious ceremonies and any other specified matters, provided that such greeting cards or invitations etc. are sent only to clients, relatives and close friends of the members concerned.

In the given case, CA. Sonu has instructed to write designation "Chartered Accountant" on invitation cards for a religious ceremony and distributed the same to all the relatives, close friends and clients of both the partners.

In this context, it may be noted that the Council has allowed using designation "Chartered Accountant" in invitations for religious ceremony, provided these are sent to clients, relatives and close friends of the members concerned only.

Therefore, CA. Sonu would be held guilty of professional misconduct under the said clause for sending such invitations to the relatives, close friends and clients of CA. Monu as well.

20. (a) Haphazard Sampling: In haphazard selection, the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

Haphazard selection of sample, may be an acceptable alternative to random selection of sample, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.

When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

(b) Key Functions of Energy Auditor: Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. In that context, energy management involves the basis approaches reducing avoidable losses, improving the effectiveness of energy use, and increasing energy use efficiency. The function of an energy auditor could be compared with that of a financial auditor. The energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party. The following are some of the key functions of the energy auditor-

(i) Quantify energy costs and quantities.

(ii) Correlate trends of production or activity to energy costs.

(iii) Devise energy database formats to ensure they depict the correct picture – by product, department, consumer, etc.

(iv) Advise and check the compliance of the organisation for policy and regulation aspects.

(v) Highlight areas that need attention for detailed investigations.

(vi) Conduct preliminary and detailed energy audits which should include the following:

(a) Data collection and analysis.

(b) Measurements, mass and energy balances.

(c) Reviewing energy procurement practices.

(d) Identification of energy efficiency projects and techno-economic evaluation.

(e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.

(f) Recommendations on goal setting for energy saving, record keeping, reporting and energy accounting, organisation requirements, communications and public relations.

(c) **Collection of Evidence by Peer Reviewer:** A Peer Reviewer collects evidence by applying the following methods-

(i) Inspection mainly consists of examination of documentation (working papers) and other records maintained by the practice unit.

(ii) Observation consists of witnessing a procedure or process being performed by others. For example, while conducting on-site review, the reviewer may review the performance of internal control.

(iii) Inquiry consists of seeking appropriate information from the partner (designated by the practice unit for the purpose)/sole proprietor or other knowledgeable persons within the practice unit. The inquiries may originate from the responses to the questions given in the questionnaire. The inquiries may also arise from the inspection of documentation maintained by the practice unit.

While observation and inquiry may be considered as external independent sources of review evidence, inspection remains the most significant method for confirming the effective observance of control procedures in the practice unit. Observation and inquiry may also corroborate the evidence provided by inspection. The reviewer, in order to carry out the review effectively, should have an understanding of the documentation maintained by the practice unit.

(d) **Compliance of Prudential Norms by NBFC:**

(i) The auditor has to verify the compliance of prudential norms relating to (1) income recognition; (2) Income from investments; (3) Asset classification; (4) Provision for bad and doubtful debts; (5) Capital adequacy norm; (6) Prohibition of granting loans against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.

(ii) The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.

(iii) The auditor should verify the classification of advances and loans as standard/ substandard/doubtfull/loss and that proper provision has been made in accordance with the directions.

(iv) Auditor should ensure that unrealised income from non-performing assets has not been taken to Statement of Profit and Loss.

(v) The auditor should check all NPAs of the previous years to verify whether during the current year any payments have been received or still they continue to be NPA during the current year also.

(e) **Circumstances in which CA in Practice or Firm of CAs Cannot Conduct Tax Audit u/s 44AB:** As per the Guidance Note on Tax Audit, a Chartered Accountant in practice or Firm of Chartered Accountants cannot conduct Tax Audit under section 44AB of the Income Tax Act, 1961 in the following circumstances -

(i) Internal Auditor whether working with the Assessee or independently practicing Chartered Accountant or firm of Chartered Accountants acting as Internal Auditor of the assessee, cannot be appointed as Tax Auditor.

(ii) A Chartered Accountant who is responsible for writing or maintenance of books of account of the assessee or any partner of such Chartered Accountant or the firm in which such Chartered Accountant is a partner cannot accept the appointment as the Tax Auditor.

(iii) A Chartered Accountant cannot accept the Tax Audit assignment in respect of a concern in which he or his relative has substantial interest.

(iv) A Chartered Accountant should not accept the tax audit of a person to whom he is indebted for more than ₹ 10,000.