

**Goenka College of Commerce and Business Administration**  
**B.Com (H) Semester Five**  
**Paper CC5.1CH: Auditing and Assurance**

**Unit 1: Concept, Need and Purpose of Audit**

**Definition**

An audit is independent examination of financial information of any entity to express an opinion thereon. The client entity may be profit-oriented (*e.g. commercial business*) or non-profit oriented (*e.g. non-Government organisation*) irrespective of its size (*e.g. large or small*) or legal form (*e.g. proprietorship, partnership, trust, company, etc.*).

**Nature of Audit**

Auditor should ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that: (a) the accounts have been drawn up with reference to entries in the books of account; (b) the entries in the books of account are adequately supported by sufficient and appropriate evidence; (c) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements; (d) the information conveyed by the statements is clear and unambiguous; (e) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and (f) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

**Objectives of Audit**

The objectives of an audit of financial statements prepared in accordance with the 'applicable financial reporting framework' and 'regulatory requirements' are: (a) to review and assess the conclusions drawn from the audit evidences and knowledge of client's business; (b) to help an auditor determine 'true and fair' view of the financial affair of the business; (c) to enable an auditor to express an opinion on financial statements; and (d) to enable an auditor to detect material misstatement in financial statements.

The objectives of the auditor are: (a) to collect reasonable assurance that the financial statements as a whole are free from material misstatement; and (b) to report and communicate auditor's findings on the financial statements as required by the SAs; and (c) to disclaim an opinion or withdraw from an engagement when reasonable assurance cannot be obtained and a qualified opinion is insufficient (SA 200).

**Users should not assume that auditor's opinion is an assurance of future viability or efficiency and effectiveness of the client entity. The auditor cannot be held liable for not being able to identify a misstatement due to inherent limitations in audit (SA-240). In the case of Kingston Cotton Mills Company, it was decided that without any doubtful situations, the auditors should rely on the management/ employees of the client entity, and thereby should act as a watchdog instead of a bloodhound.**

**Scope of Audit**

The scope of audit is determined based on: (a) engagement terms; (b) relevant regulatory requirements; and (c) ICAI pronouncements. All aspects relevant to the financial statements being audited should be adequately organised before the audit. The auditor should satisfy themselves that the information contained in the underlying accounting records and other source data are: (a) sufficient and reliable for the preparation of the financial statements based on: (i) evaluation of accounting systems and internal controls; and (ii) other tests, inquiries and other verification procedures of accounting transactions and account balances; (b) properly disclosed in the financial statements in accordance with applicable statutory requirements based on: (i) comparison of financial statements with underlying accounting records and other source data; and (ii) assessment of the selection and consistent application of accounting policies. The auditor is not supposed to function beyond his scope of competence. An auditor may not possess the technical expertise for determining physical condition of assets. The auditor may issue a qualified opinion or disclaimer of opinion on the financial statements if there are limitations in the scope of audit that weaken the auditor's ability to express an unqualified opinion.

The auditor should check the following aspects in order to determine nature, timing and extent of audit procedure: (a) Appropriateness and adequacy of the accounting system and internal control; (b) Vouching of financial statements with respect to the following: (i) Arithmetic accuracy through

verification of postings, balances, etc.; (ii) Authenticity and validity of transaction by examining the entries in the books of accounts with the relevant supporting documents; (iii) Distinction between items of capital and revenue nature; (c) Adjustment of accounting items corresponding to accounting period; (d) Preparation of balance sheet and profit and loss account or other statements in accordance with underlying records; (e) Verification of the title, existence and value of the assets and liabilities appearing in the balance sheet; (f) Expression of opinion on 'true and fair' view of: Balance sheet; Statement of profit and loss; and Cash flow statement; (g) Compliance with statutory requirements (in case of a company audit); and (h) Reporting of other matters to the appropriate person/body.

The auditor's opinion deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. It neither assures the future viability of the entity nor the efficiency or effectiveness of the management. The applicable laws and regulations may require auditors to provide opinions on: (a) effectiveness of internal control; or (a) the consistency of a separate management report with the financial statements. While requirements in the SAs are relevant in forming an opinion on financial statements, the auditor may have to undertake further work if the auditor had additional responsibilities in this regard (SA 200).

### **Basic Principles Governing Audit**

The basic principles governing audit are the following:

- (a) *Integrity Objectivity and Independence*: An auditor is a professional who is given access to entire financial records of the organization he is auditing. His opinions should be based on evidences rather than on personal intuitions. People in the organization should not doubt his independence.
- (b) *Confidentiality*: The auditor should maintain a strict confidentiality of the information acquired in the course of audit. The information should not be disclosed to a third party. If there is a legal or professional duty to disclose certain information, he may do so with specific authority. The auditor should not use the information for his personal gains or for the advantage of the third party.
- (c) *Skill and Competence*: The auditor requires specialized skill and competence to perform his audit work. The audit report has to be prepared with due care. As the professionally qualified persons act as auditors, their specialized knowledge, skills and competence acquired through study and formal course help them perform flawlessly. The auditor also needs to constantly update his skill and competence in the field of accounting and auditing. Skill and competence acquired by the auditor should be applied with due care.

### **Auditor's Independence**

Independence is considered as an essential characteristic of accounting profession. It implies that the judgement of auditor is not secondary to the desires or direction of the client (**Guidance Note on Independence of Auditor, ICAI**). Independence is a condition of mind as well as personal character. It should not be confused with the standards of independence imposed externally. The term independence can be defined as (a) Independence of Mind and (b) Independence of Appearance (**Code of Ethics, IESBA**):

#### *Independence of Mind*

It is the state of mind that allows an auditor to express an opinion without being affected by external influences.

#### *Independence of Appearance*

It is the avoidance of circumstances that would compromise integrity, objectivity or professional skepticism of an auditor.

**Provisions with respect to rights, disqualification, appointment, removal, etc. of auditors in Companies Act, 2013 and provisions with respect to professional misconduct as per Schedules of Chartered Accountants Act, 1949 aims to protect independence of auditors.**

Independence of the auditor should not only exist in fact, but every reasonable person should believe that it exists in the auditor. The auditor should satisfy himself that accepting an engagement will not impair his independence. The auditor must not allow any bias to override his integrity and objectivity and always maintain an impartial attitude. Many different circumstances may pose a threat to auditor independence requiring application of appropriate actions that may safeguard the same.

#### *Self-interest Threat*

It arises when audit firm, partner or associate has a financial interest in an audit client **Examples: (a) direct or materially significant indirect financial interest in a client; (b) loan or guarantee to or from the client; (c) undue dependence on fees; (d) close business relationship with the client; (e) potential employment with the client; and (f) contingent fees for the engagement.**

#### *Self-review Threat*

It arises during: (a) a review of any judgement reached in a previous audit; (b) non-audit engagement; and (c) a member of audit team was previously an employee of the client. **Non-audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements including management services, internal audit, investment advisory service, design and implementation of information technology systems, etc. Example: (a) an auditor having been a director or senior officer of the company; and (b) auditors perform services that are themselves subject matters of audit.**

#### *Advocacy Threat*

It arises when the auditor apparently promotes a client's opinion to make the people believe that their independence is compromised. **Example: (a) an auditor dealing in securities of the client; (b) auditor becoming the client's advocate in litigation and third party disputes.**

#### *Familiarity Threat*

It arises when the auditor becomes too sympathetic to the client's interests due to a familiar relationship with them. **Example: (a) relative of the auditor being senior employee of the client; (b) former partner of the audit firm being a senior employee of the client, (c) long association; and (c) acceptance of significant gifts or hospitality from the client, etc**

#### *Intimidation Threat*

It arises when auditors are hindered from acting independently with sufficient professional skepticism. **Examples: (a) threat of replacement over disagreements with the application of accounting principles; (b) pressure to unduly reduce work corresponding to reduced audit fees.**

The auditors should always be and appears to be independent of the client for the public to have confidence in the quality of audit. Important fundamental principles like integrity, objectivity, and professional skepticism require an auditor to be independent. The auditor should thoroughly consider threats to his independence in any assurance engagements. If the threats exist, the auditor should withdraw from the engagement; or apply appropriate safeguards to eliminate the threats. If the auditor fails to implement reliable and sufficient safeguards, then he should not accept the work.

The engagement partner should form a conclusion on compliance with independence requirements applicable the audit engagement by: (a) obtaining relevant information from the firm (*or network firms*), to identify and evaluate circumstances and relationships that create threats to independence; (b) evaluating information on identified breaches of the firm's independence policies and procedures to determine possibility of threat to independence; (c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards; or, (d) withdrawing from the engagement if threats cannot be reduced to an acceptable level; and (e) reporting to the firm his inability to resolve the matter.

## **Error and Fraud**

### *Concept*

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action resulting in the misstatement of the financial statements is intentional called fraud; or unintentional called error. Fraud is 'an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage' (SA 240).

### *Means of Doing Fraud*

Fraudulent financial reporting may be made by the following: **(a) Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared; (b) Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information; (c) Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.**

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

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

#### *Auditor's Responsibilities in Detection and Prevention of Fraud*

An auditor conducting an audit is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit. The auditor should recognize the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

#### *Difference between Auditing and Investigation*

<b>Auditing</b>	<b>Investigation</b>
Auditing is the process of examining an individual's financial statement.	Investigation is a comprehensive and careful study of the accounts books to find out the truth.
The facts gained from audit process are inferential.	Evidence gained from investigation process is critical in nature
The nature of auditing carries a general examination.	Investigation has a critical nature.
Auditing conducted on yearly basis	Investigation controlled according to the needs of the organization.
Auditing performed by chartered accountant.	Experts hired for an investigation
Auditing stands essential for every organization	Investigation is unrestricted
In case of auditing, financial reporting is general purpose.	Reporting of an investigation is private.
An auditor appointed by the shareholders of the company.	The investigator appointed by the management, shareholders or one-third party
Generally, the scope of auditing lies in giving an opinion on the company's financial statement.	The scope of the investigation is restricted to answer only those questions that are examined in the engagement letter.

## **Unit 2: Audit Procedures and Techniques**

### **Auditing Engagement (SA 210)**

#### *Preconditions of Audit*

In order to establish whether the preconditions for an audit are present, the auditor should: determine acceptability of the financial reporting framework (FRF) to be applied in the preparation of the financial statements (FS); and obtain the agreement of management that it acknowledges and understands its responsibility: (a) for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; (b) For such internal control (IC) as management determines is necessary to enable the preparation of financial statements that are free from material

misstatement, whether due to fraud or error; and (c) to provide the auditor with: (i) Access to all relevant information to the preparation of the financial statements of which management is aware (*e.g. records, documentation and other matters*); (ii) Additional information requested by the auditor from management for the purpose of the audit; and (d) Unrestricted access to persons within the entity from those the auditor is required to obtain audit evidence.

If management or those charged with governance impose a limitation on the scope of the auditor's work such that the auditor will have to issue a disclaimer of opinion on the financial statements, the auditor should not accept such an audit engagement, unless required by law or regulation to do so.

If the preconditions for an audit are not present, in terms of: (a) unacceptable financial reporting framework in the preparation of the financial statements; and (b) failure to obtain the agreement of management that it acknowledges and understands its responsibility, the auditor should: discuss the matter with management; and not accept the proposed audit engagement unless required by law or regulation to do so.

#### *Audit Engagement Terms*

The auditor should agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement should be recorded in an audit engagement letter or other suitable form of written agreement and should include the following: (a) The objective and scope of the audit of the financial statements; (b) The responsibilities of the auditor; (c) The responsibilities of management; (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from the expectation. If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities.

#### *Recurring Audits*

In case of recurring audits, the auditor should assess: requirement for revising the audit engagement; and need to remind the entity of the existing terms of the engagement. The auditor may decide not to send a new audit engagement letter or other written agreement each period unless the following issues take place: (a) Any indication that the entity misunderstands the objective and scope of the audit; (b) Any revised or special terms of the audit engagement; (c) A recent change of senior management; (d) A significant change in ownership; (e) A significant change in nature or size of the entity's business; (f) A change in legal or regulatory requirements; (g) A change in the financial reporting framework adopted in the preparation of the financial statements; and (h) A change in other reporting requirements.

#### *Change in Engagement*

The auditor should not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. If the auditor is requested to change the audit engagement that conveys a lower level of assurance prior to its completion, he should determine any reasonable justification for doing so. If the terms of the audit engagement are changed, the auditor and management should agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement. If the auditor cannot agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor should: (a) withdraw from the audit engagement where possible under applicable law or regulation; (b) determine any contractual or other obligation to report the circumstances to other parties (*e.g. those charged with governance, owners or regulators*). The entity may request the auditor to change the terms of the audit engagement because of: (a) a change in circumstances affecting the need for the service; (b) a misunderstanding as to the nature of an audit as originally requested; or (c) a restriction on the scope of the audit engagement imposed by management or caused by other circumstances. The auditor considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement. If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement. However, the work required to be performed and the report to be issued should be appropriate to the revised engagement. The report on the related service would not include reference to: (a) The original audit engagement; or (b) Any procedures that may have been performed in the original audit engagement. If the audit engagement is changed to an engagement to undertake agreed-upon

procedures, reference to the procedures performed is a normal part of the report.

#### *Additional Considerations*

If financial reporting standards (FRS) established by an authorised or recognised standards-setting organization are supplemented by law or regulation, the auditor should determine whether there are any conflicts between the two. In case of conflict, the auditor should discuss with management the nature of the additional requirements and should agree on the following: (a) Compliance with the additional requirements through additional disclosures in the financial statements; or (b) Amendment of the description of the applicable financial reporting framework in the financial statements; or (c) Determine necessity of modifying auditor's opinion if none of the above two actions are not possible (SA 705).

If the law or regulation applicable to the entity prescribes the layout or wording of the auditor's report that are significantly different from the requirements of SAs, the auditor should evaluate: (a) any misunderstanding that may have been created from the assurance obtained from the audit of the financial statements; and (b) need for an additional explanation in the auditor's report that can mitigate possible misunderstanding (SA 706). If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor should not accept the audit engagement, unless required by law or regulation to do so. The auditor should not include any reference within the auditor's report to the audit having been conducted in accordance with SAs, since the law or regulation applicable to an entity does not comply with SAs (SA 700).

### **Audit Planning (SA 300)**

#### *Meaning*

Audit plan encompasses developing an overall plan for the expected scope and conduct of the audit and developing a programme keeping in view the nature, timing and extent of audit procedure. It is a continual and iterative process in auditing that begins shortly after the completion of or in connection with the previous audit and continues till the completion of current audit engagement. It is necessary to conduct audit in an efficient and timely manner.

#### *Coverage*

An audit plan cover the following issues: (a) Gathering of knowledge on client's accounting system, policies and internal control procedures; (b) Setting up expected degree of reliance to be placed on internal control; (c) Deciding the nature, timing and extent of audit procedure; and (d) Coordinating the work to be performed.

#### *Benefits*

Audit Plan (a) helps to devote appropriate attention to important areas; (b) identifies and resolves potential problems on a timely basis; (c) assists in selection of engagement team members with appropriate competence and in delegation of responsibilities to them; (d) facilitates direction, supervision and review of the audit work; (e) assists in coordination with component auditors or experts; (f) is organised and managed in an effective and efficient manner.

#### *Preliminary Engagement Activities*

The auditor should undertake the following activities at the beginning of an audit engagement: (a) Performing procedures with respect to continuance of the client relationship and the specific audit engagement (SA 220); (b) Evaluating compliance with ethical requirements, including independence (SA 220); (c) Establishing an understanding of the terms of the engagement (SA 210).

#### *Development of Audit Plan*

The plan should include a description of the following: (a) The nature, timing and extent of planned risk assessment procedures (SA 315); (b) The nature, timing and extent of planned further audit procedures at the assertion level (SA 330); and (c) Other planned audit procedures that are required to be performed so that the audit complies with SAs.

The auditor should obtain an understanding of the following information about the client's business (SA 315): (a) Relevant industry, regulatory and other external factors including the applicable financial reporting framework (**Ex: The dynamic external system; customer relationship with supplier; technological changes**); (b) Nature of the entity: its operation; its ownership and governance structure; types of investments the entity is making and is planning to make; investments in special purpose entities

(SPEs); structure and financing of the entity [**Example: (a) Knowing of sources of an entity's earnings (b) Realizing of the key supplier and customer relationships; (c) Information about components in multiple tax jurisdictions, resulting in additional risk of misstatement in the tax accounts; (d) Information related to an acquisition by the entity resulting in a complex structure of holding companies giving rise to significant intercompany transactions leading to material misstatements due to fraud or error; (e) Transactions beyond the entity's normal course of business;**]; (c) The entity's selection and application of accounting policies, including the reasons for changes thereto; (d) The entity's objectives and strategies (**Example: (a) If one of entity's objectives is to develop the business, a stable but regular growth strategy may be developed through specific marketing campaigns and development of new markets; or (b) A more aggressive strategy may be developed in acquiring competitors**) and those related business risks (**Example: inability to cope with new products, technologies or services; extreme reliance on a key supplier; deficiency of human resources with proper expertise; scarce production capacity**) that may result in risks of material misstatement; (e) The measurement and review of the entity's financial performance (**Example: External information are required to be obtained from the analysts' reports and credit rating agency reports for an understanding of entity's performances measures.**)

#### *Continuity of Audit Plan*

Planning includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures (**Example: Prior to the auditor's identification and assessment of the risks of material misstatement, the plan includes the following: the analytical procedures; legal and regulatory framework and compliance with such framework; exploring of materiality.**)

#### *Auditor's Responsibility*

The responsibilities of an auditor with respect to an audit plan are: (a) to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement; (b) to take care of the overall audit strategy and audit plan in order not to compromise the usefulness of the audit even in the absence of any discussions with the management; (c) to draw on the experiences and insight of the engagement partner and other key members of the engagement team in the planning process, thereby enhancing the effectiveness and efficiency of the audit.

#### *Change in Audit Plan*

The auditor should update and change the overall audit strategy and the audit plan as required during the course of the audit. The auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures as a result of unforeseen events, changes in conditions, or the audit evidence obtained from the results of audit procedures based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's notice that differs significantly from the information available when the auditor planned the audit procedures.

#### *Direction Supervision and Review*

The auditor should plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. It depends upon the following factors: (a) The size and complexity of the entity; (b) The area of the audit; (c) The assessed risks of material misstatement; and (d) The capabilities and competence of the individual team members performing the audit work.

#### *Documentation*

The auditor should document the following: (a) *Overall audit strategy*: Documentation is the record of the key decisions considered essential to properly plan the audit and to communicate significant matters to the engagement team; (b) *Audit plan*: Documentation is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks; (c) *Significant changes*: Documentation is a record of any significant changes made during the audit engagement to the overall audit strategy and resulting changes to the planned nature, timing and extent of audit procedures, with reasons thereof and appropriate responses to the significant changes occurring during the audit.

#### *Additional Consideration*

In case of an initial audit engagement, the auditor may need to expand the planning activities because the auditor does not usually have the prior experience with the entity which is usually present while planning recurring engagements. The auditor should carry out the following activities prior to beginning an initial

audit engagement: (a) Performing procedures regarding the acceptance of the client relationship and the specific audit engagement (SA 220); (b) communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements.

### **Audit Programme**

An audit programme is a detailed plan of techniques and procedures designed by the auditor for the purpose of obtaining sufficient evidence to enable the auditor to communicate an informed opinion on such statements. Audit programme should be drawn up in respect of each audit and more particularly for bigger audits. It provides the basis for supervision and control of audit work. Audit objectives of each step are contained in the programme. The steps in an audit programme are interrelated. It is a comprehensive plan of applying the audit procedures in the given conditions with directives for the suitable techniques to be adopted for accomplishing the audit objectives.

### **Audit Documentation (SA 230)**

#### *Audit Working Paper*

Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (Terms such as “working papers” or “work papers” are also sometimes used.)

Audit documentation provides: (a) evidence of the auditor’s basis for a conclusion about the achievement of the overall objectives of the auditor; and (b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Audit documentation may be recorded on paper or on electronic or other media. The auditor may include copies of the entity’s records (**Example: significant and specific contracts and agreements**) as part of audit documentation. Audit documentation is not a substitute for the entity’s accounting records. The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

#### *Ownership of Audit Working Paper*

SQC 1 provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

#### *Audit File*

Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

### **Permanent Audit File**

Permanent audit file should include: (a) information regarding legal and organisational structure of the company (e.g. AOA, MOA, relevant acts and regulations/ partnership deed); (b) extract of copies of relevant legal documents, agreements and minutes of the meeting; (c) a narrative description/questionnaire/flow chart of evaluation of internal control system; (d) copies of audited F.S. of P.Y.; (e) analysis of significant ratios and trends; (f) copies of management letters issued by the auditors; (g) record of communication with retiring auditor before appointment; (h) notes regarding significant accounting policies; (i) significant audit observations of P.Y.

### **Current Audit File**

Current audit file should include: (a) correspondence regarding acceptance of re-appointment; (b) relevant extracts of minutes of meetings of BOD or AGM; (c) evidence of the planning process and audit programme; (d) analysis of transaction and balances; (e) record of NTE of audit procedures performed and results obtained; (f) evidence that work performed by assistants are supervised and reviewed; (g) copies of communication with other auditors, experts and third parties; (h) copies of letters or notes on matters communicated with client, terms of engagement and weakness in relevant internal control; (i) letters of representation and confirmation received from the client; (j) conclusions reached on significant



aspects and the manner in which the unusual issues have been resolved; (k) copies of financial information being reported on and related audit report.

### **Assembly and Custody of Final Audit File**

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than 7 years from the date of the auditor's report, or, if later, the date of the group auditor's report.

### *Audit Notebook*

Audit notebook is a bound notebook which records queries that require clarification, explanation and investigation and the manner in which they were resolved. The audit notebook is generally divided into 2 parts: (A) general information (e.g. **(a) nature of business carried on; (b) important provisions in MOA, AOA or deeds affecting its function; (c) structure of the financial and administrative organisation; (d) list of books of A/c; (e) name and responsibilities of principal officers; (f) particulars of accounting system and internal control in operation; (g) particulars of accounting policies; (h) collaboration or royalty contracts to which the client is a party**); and (B) special information [e.g. **(a) audit queries (missing vouchers) not cleared immediately; (b) irregularities observed during the course of audit (failure to comply with relevant acts, regulations, MOA and AOA, change in the method of valuing closing stock, WIP and fixed assets, etc.); (c) unsatisfactory book keeping arrangements, costing method, internal administration; (d) information about the company not apparent from the A/c; (e) special points requiring clarification at the time of verification final A/c; (f) important matters for future reference**]

The importance of audit notebook are: (a) observations that require follow up are maintained systematically; (b) it is a basic document containing unsettled observations which are referred while preparation of audit report; (c) it provides new direction to the NTE of audit; (d) it shows the extent of work done when the assistants are shifted or there is a temporary stoppage of work; (e) it defends the auditor against charges of negligence and other shortcomings in audit; (f) it is useful for next audit and preparing next audit programmes as weakness on various aspects would require close follow-up.

### *Audit Memorandum*

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes: (a) the significant matters identified during the audit and; (b) how they were addressed. Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives.

### **Audit Evidence**

#### *Concept*

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Audit evidences include: (1) Information contained in the accounting records [e.g. **(a) the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; (b) invoices; (c) contracts; (d) the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and (e) records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures**] and (2) Other information that authenticates the accounting records and also supports

the auditor's rationale behind the true and fair presentation of the financial statements [e.g. (a) minutes of the meetings; (b) written confirmations from trade receivables and trade payables; (c) manuals containing details of internal control etc.]. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

### *Needs*

The auditor is required to express his opinion on whether the F.S. shows a true and fair view. SAs require that the auditor should obtain sufficient appropriate evidence, through the performance of compliance and substantive procedure. This enables the auditor to draw reasonable conclusions on which he should base his opinion on the F.S. The auditor requires evidence to enable him to form and express his judgement on the F.S. The auditor should evaluate whether he has obtained sufficient appropriate evidence before he draws his conclusion. Audit evidence in total should enable an auditor to form an opinion on the financial statements.

### *Procedures of Obtaining Audit Evidence*

Audit procedures to obtain audit evidence can include: (a) Inspection; (b) Observation; (c) External Confirmation; (d) Recalculation; (e) Re-performance; (f) Analytical Procedures; (g) Inquiry.

#### **Inspection**

Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

Some documents represent direct audit evidence of the existence of an asset [**Ex: document constituting a financial instrument such as an inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.**] Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

#### **Observation**

Observation consists of looking at a process or procedure being performed by others. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

#### **External Confirmation**

An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions.

#### **Recalculation**

Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

#### **Re-performance**

Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

#### **Analytical Procedures**

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

#### **Inquiry**

Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained [**Ex: information regarding the possibility of management override of controls**]. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures. Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

### **Routine Checking**

It is a detailed checking of all transactional aspects such as casts, sub-casts, carry-forwards, extensions, and calculations, etc. in subsidiary books, checking of posting into ledgers, casting of ledger accounts and extraction of their balances. It is performed to (a) verify the arithmetic accuracy of the entries; (b) verify accuracy of posting to ledgers; (c) check that ledger accounts have been properly balanced; (d) ensure that no figures are altered after checking.

Major advantages of routine checking are as follows: (a) checking of posting and ledgers; (b) arithmetic accuracy can be checked; (c) trial balance tally is facilitated; (d) easy detection of errors and frauds; (e) delegation of audit work to junior level staff.

The disadvantages of routine checking are as follows: (a) highly mechanical process; (b) monotonous activity may lead to boredom; (c) major items of fraud or high level of intricacies may not be revealed; (d) compensating errors and errors of principle may not come to limelight.

### **Test Checking**

It is an accepted auditing procedure where only a part of its transactions is checked to form an opinion instead of checking all the transactions. The main purpose of test checking is to obtain reasonable level of satisfaction about all transaction but verifying a few representative sample transactions.

The features of test checking are: (a) the opinion based on test checking can be relied upon since it is based on statistical theory of sampling, not on any arbitrary method; (b) it cannot provide complete reliability since it is a process of estimation where error for a particular matter under examination depends upon individual judgement; (c) entries involving large amounts of some material accounts or entries for few specific months are checked exhaustively and the remaining entries are picked up for verification as per a plan; (d) test check are normally planned in such way so that audit programmes of 3-5 years cover all types of transactions (**e.g. entries of January, June and December are checked in 1<sup>st</sup> year, while entries of April, July and September are checked in the 2<sup>nd</sup> year**); (e) the staff and management should not be able to detect the pattern of test checking, otherwise they will predict the areas and periods to be covered in any year and will be cautious about them; (f) the auditor should keep changing the method of test checking reasonably in frequent intervals, so that it does not become routine, predictable and mechanical; (g) extent of test checking depends on auditor's professional judgement, which in turn depends upon auditor's experience, current development and efficacy of internal control.

The factors to be considered for deciding the extent of test checking are: (a) size of the organisation; (b) state and efficacy of internal control; (c) adequacy and reliability of books of records; (d) tolerable error range; (e) degree of the desired confidence.

A good test check will provide sufficient satisfaction to auditors if (a) it is based on appropriate size of representative sample; (b) sample is selected on a random basis; (c) chance of being arbitrary or biased in sample selection is low; (d) capable of giving results with calculated degree of risk.

Test checks are used in the following situation: (a) in case of big concerns where number of transactions are large; (b) the auditor has a little time at his disposal to carry out audit procedures; (c) transactions are identical or of homogenous nature; (d) a satisfactory manual or computerised internal control exists in the company.

The major advantages of test checking are: (a) it is time-saving; (b) careful test checking serves audit objectives; (c) volume of work reduced; (d) time available for other audits; (e) effective utilisation of audit expertise as it involves application of mind and intelligent judgement; (f) if certain aspects of internal control do not create suspicion, it is not necessary to verify all transactions exhaustively; (g) the auditor assesses the risk of material misstatement in financial statements in a scientific manner by drawing samples and checking them in detail.

The disadvantages of test checking are: (a) client staff may become careless and may predict the pattern if element of surprise is not available; (b) some material errors and fraud may go undetected which may lead to increase in the level of inherent audit risk; (c) all items of transactions are not checked; (d) an element of doubt is present in auditor's opinion; (e) there may be a possibility of auditor's bias in selection of representative sample of appropriate size; (f) it lacks authenticity, precision, acceptable basis and does not give an idea about the degree of reliability that can be placed on the findings for application on the whole set; (g) it may not be a scientific mechanism if number of transactions are decided arbitrarily; (h) if the activity level vary in a year (**e.g. peak sales in a few months**), the auditors will not be able to draw reasonable conclusion based on a study of few specific months.

The important precautions to be taken in case of test checking are: (a) the transactions should be classified into sub-groups or stratified if wide variations exists between same class of transactions; (b) system of entering and processing a transaction (**e.g. evaluation of authorisation, documentation, recording and evidencing**) should be studied sequentially; (c) the auditor should satisfy himself about the efficiency, soundness and capability of internal control system in producing reliable accounting and financial data; (d) a properly thought-out plan of the test check should be prepared and the auditing staffs should understand the objectives of each check; (e) transactions falling under each test should be selected using random number tables; (f) select areas (**e.g. depreciation and payment to directors**) should not come under the purview of test check and should be separately listed; (g) the number of transactions to be tested for each test-check plan should be determined from the statistical tables based on the degree of reliance and confidence in the test check results; (h) criteria to judge material error should be construed since immaterial errors are not likely to distort the overall truth and fairness.

The items that are not suitable for test checking are: (a) opening and closing entries; (b) BRS; (c) loans, advances and other assets and liabilities; (d) matters involving estimation and computation (**e.g. depreciation, royalty**); (e) material and important transactions that may be small in number; (f) transactions that should be carefully evaluated as per statutory requirement (**e.g. managerial remuneration, dividends, shares issued for cash, etc.**); (g) seasonal industry; (h) non-recurring or exceptional items; (i) statutory dues or payments (**e.g. ESI, EPF, TDS, etc.**).

### **Auditing in Depth**

It means examining a few select transactions from beginning to the end through the entire flow of transaction. It involves studying the recording of transactions at various stages through which they have passed. The following aspects are to be verified: (a) relevant records and the person who has authorised such transaction are fit to do so as per prescribed procedure; and (b) accounting and operational aspects of the select transactions. A representative sample should be chosen for this purpose and they must be traced meticulously. In each stage of verification, auditor's confidence on the functioning of the system increases which lead to selection of smaller number of transactions at each stage on statistical grounds. It reconstructs the auditing trail and provides more insight into the functioning of client's system rather than haphazard and mechanical approach to testing.

### **Analytical Procedures**

#### *Meaning*

Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like comparisons, trend and ratio analysis in addition to reasonable tests. These collectively are known as overall tests. With the passage of tests,

analytical procedures have acquired lot of significance as substantive audit procedure. SA 520 discusses the application of analytical procedures during an audit.

As per the SA 520 the term analytical procedures means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Analytical procedures include the consideration of comparisons of the entity's financial information as well as consideration of relationships.

Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information. Thus, we can say that Analytical Procedures may be segregated into the following major types: (a) as comparison of client and industry data; (b) comparison of client data with similar prior period data; (c) comparison of client data with client-determined expected results; (d) comparison of client data with auditor-determined expected results and (e) comparison of client data with expected results, using non financial data.

The objectives of the auditor are: (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

#### *Substantive Procedure*

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level. The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

#### **Factors**

The auditor should consider the following factors for Substantive Audit Procedures:

- The *availability of reliable and relevant data* will facilitate effective analytical procedures;
- The degree of *disaggregation* in available data can directly affect the degree of its usefulness in detecting misstatements;
- Substantive analytical procedures are more useful for *certain types of accounts* than for others. Income statement accounts tend to be more predictable because they reflect accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greater management judgment;
- Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions, **(e.g., through routine processes)**. Whereas the transactions recorded by non-routine and estimation SCOTs (Significant Classes of Transactions) are often subject to management judgment and therefore more difficult to predict;
- Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are *predictable* **(e.g., between sales and cost of sales or between trade receivables and cash receipts)**. A predictable relationship is one that may reasonably be expected to exist and continue over time;
- Substantive analytical procedures may be more effective in providing evidence for some *assertions* **(e.g., completeness or valuation)** than for others **(e.g., rights and obligations)**. Predictive analytical procedures using data analytics can be used to address completeness, valuation/measurement and occurrence;

- When we are designing audit procedures to address an *inherent risk* or “*what can go wrong*”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

### Techniques

The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

- *Trend Analysis* is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. The auditor evaluates whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change. In other words, trend analysis implies analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.
- *Ratio Analysis* is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., **the trade receivables balance related to sales**). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.
- Unlike trend analysis, *Reasonable Test* does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., **occupancy rates to estimate rental income or interest rates to estimate interest income or expense**). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.
- A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

### Analytical Procedure

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall: (a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions; (b) Evaluate the reliability of data from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source comparability, and nature and relevance of information available, and controls over preparation; (c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

### Audit of Educational Institutions

#### *Preliminary Work*

#### **Legal Compliance**

The auditor should examine the constitution of the institution incorporating charters, trust deeds, applicable Acts/legislature and underlying rules and regulation affecting its accounts.

#### **Internal Check**

The auditor should: (a) ensure that the resolutions regarding bank A/C operations and sanctioning of expenditure as obtained from the minute of the meetings of the managing committee have been duly complied with; (b) evaluate the internal control system; (c) identify different heads of incomes and expenditures from sanctioned budget or financial statements; (d) verify whether the financial statements are presented as per appropriate ASs and other legal requirements; and (e) obtain appropriate management representations.

#### *Audit of Receipts*

#### **Student Fees**

The auditor is required to: (a) verify names of students in fee register with their class register for each term; (b) check whether fees charged are as per specified rates; (c) check whether demand for fees are raised against students; (d) verify fees received as per fee register from counterfoil of receipts and entries in the cash book and bank book; (e) trace whether revenue from student fees are accounted; (f) ensure that the advance fees are carried forward; (g) report old arrear fees to the managing committee and ensure that irrecoverable arrear fees are written off; (h) compare admission fees with admission slips signed by the institutional head; (i) confirm that the admission fees are credited to the capital fund unless otherwise decided by the managing committee; (j) verify that the refundable portion of the caution money is shown as liability; (k) ensure that free studentship and concessions are authorised and under the rules framed by the managing committee; (l) confirm that fines for late fees or fines for absence are appropriately collected and banked; and (n) confirm recovery of hostel dues before closure of student's accounts and refund of caution money.

#### **Rent**

The auditor should vouch rental incomes from properties utilised for public functions based on rent agreements, rent rolls, and counterfoil of rent receipts with bank pass book.

#### **Investment Income**

The auditors may vouch the accounting of investment income (**e.g. interest and dividend from endowments, legacies, and other investments**) against investment register and bank pass book.

#### **Grants**

The auditors should: (a) verify a Government or local authority grant with the sanction letter; (b) ascertain the reasons for disallowing an expense for a grant; (c) vouch donations with the list published in annual report and counterfoil of receipts issued to donors; (d) ensure maintenance of general and specific donations in separate accounts; and (e) check utilisation of specific donations for its intended purpose.

#### *Audit of Payments*

##### **Student Expenditure**

The auditor should: (a) verify the basis for granting scholarships and vouch it with acknowledgement from students and scholarship register; (b) check the payments in the form of prize distribution; (c) see authorisation and accounting of payments towards library books and sports items; and (d) ensure that inspection procedure for receipt and issue of provisions (**e.g. food staffs, clothing and other equipments, etc.**) is efficient and all bills are duly authorised before payments.

##### **Staff Expenditure**

The auditor should: (a) verify the terms and conditions of staff salaries; (b) check the calculations of salary and deductions thereof; (c) ensure payment of salary against staff signature; (d) vouch staff salary against salary register and bank pass book; and (e) ensure that increase in salary is sanctioned by the managing committee.

##### **Capital Expenditure**

The auditor should: (a) verify that all capital expenditures are sanctioned by the committee; (b) vouch establishment expenses (**e.g. electricity, water bill, hostel maintenance**) and identify heavy unsanctioned expenditure under any head and obtain suitable explanation from the committee.

##### **Tax Expenses**

The auditor should: (a) verify tax exemptions subject to fulfilment of certain conditions; (b) ensure refund claims on TDS from rent and investment incomes.

#### *Audit Assets*

##### **Fixed Assets**

The auditor is required to: (a) examine proper accounting of fixed assets; (b) verify ownership, existence and valuation of fixed assets by physical verification; and (c) check calculation of depreciation.

##### **Investment**

The auditor is required to: (a) ensure maintenance of endowment funds for prizes and investment of excess amount; and (b) verify investment of staff provident fund in appropriate securities.

##### **Inventory**

The auditor is required to test check the number and valuation of stocks (**e.g. furniture, stationery, clothing, provision and all equipment etc.**) from inventory register and previous year information.

### **Banks**

The auditor is required to: (a) vouch the entries and totals in cash collection register with counterfoil of receipts and column totals; (b) verify the denominations of cash and cheque collected in cash collection register; (c) comparing the pay-in-slips for cash and cheque deposited with the register; (d) test check the entries in cheque register and passbook and identify collection/dishonour of cheques; (e) verify presence of a system for recording receipts against students' name and head of account in case of direct deposit; (f) ensure authorisation for funds transferred from collection A/c to an expenditure A/c; (g) check BRS of the current and previous period to identify unusual entries; and (h) ensure correctness of bank balance from bank certificate.

### *Audit of Liabilities*

The auditor should verify maintenance of separate statements of different funds (**e.g. capital fund, poor boys fund, games fund, hostel and staff provident fund, etc.**) and compare them with previous year figures.

### **Audit of Hospitals**

#### *Preliminary Activities*

#### **Legal Compliance**

The auditor may be required to: (a) check the letter of appointment to ascertain his responsibilities; and (b) study the charter/trust deed of the hospital especially the provisions affecting accounts.

#### **Internal Check**

The auditor may be required to: (a) verify the internal check regarding receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. to ensure that purchases are duly authorised and recorded in stock register; (b) ensure the effectiveness of the accounting system; (c) compare budgeted incomes and expenditures with the actual ones and report significant deviations to the managing committee; (d) verify presentation of financial statements as per ASs and other legal requirements; and obtain management representation and certificate on different audit aspects.

### *Audit of Receipts*

#### **Income from Patients**

The auditor should: (a) vouch the register of patients with copies of bills issued; (b) crosscheck bills for a period with the patients' attendance record to ensure their appropriate preparation (**e.g. calculation and bifurcation into different items**); (c) ensure issuance of bills to all patients with dues; (d) obtain satisfactory explanations for unbilled/concessional billings; and (e) ensure that irrecoverable bills are carried forward or written off with proper authorisation.

#### **Grants**

The auditor should: (a) check purpose of all Government or local authority grants from copies of correspondence and ensure their appropriate accounting; (b) determine that legacies and donations received for a specific purpose have been so applied; and (c) ascertain classification of revenue and capital for various grants.

#### **Investment Income**

The auditor should: (a) ensure collection of rent, dividend, and interest on securities with reference to property and investment register; and (b) ensure follow-up of collectible dues.

### *Audit of Payments*

#### **Purchase and Others**

The auditor is required to: (a) vouch all purchases and expenses and obtain explanations for abnormal and non-recurring items (**e.g. high value medicines**); (b) verify that the capital expenditure are sanctioned by the trustees or the managing committee; (c) compare expenditures with previous year figures; and (d) verify that salaries to staffs are authorised and are calculated as per pay rules.

#### **Tax**

The auditor is required to: (a) verify the calculation and accounting for provision for taxation; and (b) ensure that refund on TDS is claimed if the hospital is eligible.



### *Audit of Assets*

#### **Cash**

The auditor is responsible for: (a) checking cash collections in the cash book with documentary evidences (e.g. **copies of patients bills, receipts, counterfoils of dividend and other interest warrants, copies of rent bills, etc.**); (b) tracing all subscription and donations to the respective registers and reconcile collected and due amounts; (c) conducting surprise test to all cash holding locations; and (d) ensuring cash deposit on the same day/the following day.

#### **Stocks**

The auditor is responsible for: (a) ensuring physical verification of a percentage of year-end inventories; and (b) comparing their values with respective ledger balances.

#### **Property and Investment**

The auditor is responsible for comparing shares, bonds, scrips and property deeds with the particulars entered in property and investment register.

#### **Fixed Assets**

The auditor is responsible for: (a) checking ownership, existence, valuation and accounting of fixed assets from relevant records and physical inspection; and (b) ensuring writing off of depreciation at appropriate rates against different classes of assets.

### *Audit of Liabilities*

The auditor may: (a) scrutinise sundry creditors for goods and services to identify abnormal items; (b) verify share capital, reserves and secured and unsecured loans; and (c) verify increase in capital fund as compared to the previous year.

### **Audit of Hotels**

#### *Preliminary Activities*

#### **Legal Compliance**

The auditor should: (a) note down the provisions relating to accounts from the MOA and AOA of the hotel; (b) examine the scope of audit from the appointment letter; (c) understand the entity and its environment to assess the risk of material misstatement and appropriate responses; (d) study the provisions of applicable statutes (e.g. **Shops and Establishment Act, GST Act, Department of Tourism regulations, RBI regulations, Foreign Exchange Management Act 1999 etc.**); (e) ensure conditions of licence for running the hotel are fulfilled; (f) examine the internal rules of the hotel; (g) study the minutes of the GB meetings with respect to important decisions; (h) verify form and presentation of financial statements as per ASs; and (i) obtain management representation on various audit matters.

#### **Internal Control**

The auditor should: (a) perform compliance test on system of internal control; (b) obtain a list of accounting records and policies adopted; (b) examine the internal control system regarding: (i) process of customer bills in room service and sundries; (ii) process of issue of provisions and commodities; (iii) safe custody of edibles, beverages, drinks, crockery, cutlery, linen, furniture; (c) examine the regular/weekly trading A/c for each sales point and obtain explanations regarding deviations in anticipated and actual profit percentages; and (d) increase the scope of audit tests or qualify his report if material discrepancy in gross margin remain unexplained.

### *Audit of Receipts*

#### **Room Rent**

The auditor is required to: (a) test check the guest bills (prepared by receptionist/front office/ night auditor) with the guest register to verify collection from room sales; (b) vouch daily totals in the visitors ledgers from cash book and impersonal ledger; (c) investigate into any discrepancy in charged rate and standard rate and ensure its authorisation; (d) compare daily occupancy reports (including extra bed supply) prepared by the housekeeper with the guest register and guest bills; (e) ensure proper accounting of unbilled occupancy; (f) vouch room rent receipts and ensure their correct posting; and (g) be extra cautious for payments in foreign currency or through credit cards.

#### **Restaurant Income**

The auditor is required to: (a) reconcile total sales with numerically controlled bills/bill rolls issued at the sales point; (b) check numerical control to ensure inclusion of the bills in totals; (c) vouch sale of foodstuffs, drinks from cash memos, daily report of the cashier and the cash book; (d) check credit sales from the total and detail in the guest bills; and (e) verify a few bills with kitchen order tickets (KOTs) or basic record to ensure order in revenue cycle.

#### **Other Income**

The auditor is required to ensure collection of tariffs and maintenance of records for booking of halls and other premises for special parties/shows (**e.g. marriages, receptions, conferences, seminars, boutiques etc.**) from agreement with the parties and counterfoils of money receipts.

#### *Audit of Payments*

##### **Purchases**

The auditor should: (a) check the authorisation of purchase of stocks (**e.g. foodstuffs, crockery, linen, etc.**) from the stock register; (b) vouch payments from copies of bills issued to vendors; and (c) vouch purchase of magazines and journals from vendor bills.

##### **Labour**

The auditor should: (a) test check payments to permanent staffs from cash book, service contracts and salary registers; (b) compare payments with previous periods; and (c) verify adequacy of records (**e.g. from wage payment registers and attendance records**) for casual labours employed in different departments and identify possible manipulations and suggest appropriate controls to management.

##### **Taxes**

The auditor should ensure that taxes collected from food and occupation is remitted to the proper authorities.

##### **Commission**

The auditor should: (a) ensure recovery of money against bills from travel agents, hospitality agents, corporate and other booking agents as per the terms of credit; (b) check appropriateness of commission paid to them with the related agreements.

##### **Others**

The auditor should: (a) see that cost of repair and maintenance are treated as revenue; (b) vouch payments with bills and receipts submitted; (c) see that cost of major changes, re-decoration, renovations and additions (**e.g. construction of a health club**) are capitalised; (d) verify payments made to foreign collaborator as per agreement.

#### *Audit of Assets*

##### **Fixed Assets**

The auditor may be required to: (a) obtain a schedule of fixed assets and ensure provision of adequate depreciation; (b) verify consistency in depreciation method; (c) conduct physical inspection of assets; and (d) examine method of recording and ensure that quasi-fixed assets (**e.g. silver, cutlery, etc.**) are not taken as inventory.

##### **Stocks**

The auditor may be required to: (a) examine the documentation of all movable/saleable inventories (**including food and beverages**) to exercise control over stores and sales points; (b) ensure that documents are appropriately processed; (c) see that large quantities of inventories are kept under the supervision of departmental manager; (d) ensure only trusted/authorised personnel visit the store; (e) ensure prohibition/supervision on all unauthorised access; (f) ensure authorisation and recording of all movement of stocks; (g) physically verify stocks and test check price calculations; (h) verify reasonableness and consistency of the independent valuation of stocks by professional valuers; and (i) check adequacy of provisions for replacement of stocks (**e.g. carpets, linen, etc.**).

##### **Cash and Foreign Currency**

The auditor may be required to: (a) physically check cash and obtain BRS; and (b) ensure application of appropriate rate in conversion of foreign currency.

#### *Audit of Liabilities*

### Loans

The auditor should: (a) inspect the loan agreement if the hotel has taken a long term loan from bank; and (b) check regularity of interest payment.

### Other Liabilities

The auditor should: (a) check proper accounting of all other liabilities; (b) ensure disclosure of outstanding expenses as liabilities; and (c) verify share capital, reserves and surplus, secured and unsecured loans.

### Analytical Review

The auditor is required to: (a) ensure accounting of physical stock consumption based on customers' bills or appropriate consumption A/c on the sampling basis; (b) compare occupancy rate with other similar hotel and investigate into the reasons of deviations; and (c) compare receipts and expenses with previous year figures as regards average occupancy and change in rates.

## Unit 5: Company Audit

### Appointment of Auditor [u/s 139]

*Subsequent Auditor of Non-Government Company [u/s 139(1) of Companies Act, 2013]*

- **Appointment by Company:** Every company should appoint an individual or a firm as an auditor at the first Annual General Meeting (AGM). [Note: (a) For the purpose of this section, appointment includes reappointment; (b) It is applicable to all companies except Government Companies, any other companies, owned and controlled, directly or indirectly by the Central/ State Governments.]
- **Tenure of Auditor:** The auditor should hold office from the conclusion of the first AGM till the conclusion of the sixth AGM and thereafter till the conclusion of every sixth AGM.
- **Manner and Procedure of Selection [Rule 3 of Companies (Audit and Auditors) Rules 2014 (CAAR)]:** Audit Committee (in companies where Audit Committee is required to be constituted u/s 177) or Board of Directors (BOD) (where Audit Committee is not required) should consider as to whether the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor are commensurate with the size and requirements of the company. The committee or the BOD should consider any pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India (ICAI) or any competent authority. The committee or the BOD may call for other information from the proposed auditor. The committee or the BOD should recommend the name of an individual or a firm as auditor to the BOD or to the members respectively for consideration. If the BOD agrees with the recommendation of the Audit Committee, it should further recommend the appointment of an individual or a firm as auditor to the members in the AGM. Otherwise, it should refer back the recommendation to the committee for reconsideration citing reasons for such disagreement. If the committee decide not to reconsider its original recommendation after considering the reasons given by the BOD, the later should record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the AGM.
- **Certificate by Auditor:** A written consent and a certificate are to be obtained from the auditor to the effect that the appointment is to be made as per prescribed conditions and the auditor satisfies the criteria u/s 141.
- **Content of the Certificate (Rule 4 of CAAR):** The certificate should contain the following: (a) The individual or the firm is eligible for appointment and is not disqualified for appointment under the Act, the Chartered Accountants Act, 1949 and the rules or regulations made there under; (b) The proposed appointment is as per the term provided under the Act; (c) The proposed appointment is within the limits laid down by the Act; and (d) The list of proceedings against the auditor or audit firm or any partner of the audit firm pending with respect to professional misconduct is true and correct.
- **Intimation to Auditor:** The company should inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the AGM in which the auditor is appointed in Form No. ADT -1.

### Rotation of Auditor [u/s 139(2)]

- **In Case of Individual Auditor:** No listed companies or other prescribed companies should appoint or re-appoint an individual as auditor for more than one term of five consecutive years. The auditor so

appointed is not eligible for re-appointment as auditor in the same company for five years from the completion of his term.

- **In Case of Audit Firm as Auditor:** Listed companies or other prescribed companies should not appoint or re-appoint an audit firm as an auditor for more than two terms of five consecutive years. The firm so appointed is not eligible for re-appointment in the same company for five years from the completion of such term. [Example: M/s PQR & Co., a Chartered Accountant firm was appointed by Q Ltd. as the statutory auditor in its AGM for 12 years. The appointment was not valid as the appointment can be made only for 2 consecutive terms of 5 years each, which also should not be made in the same AGM. There is also a cooling-off period of 5 years after completion of two terms.]
- **Restriction on Other Audit Firms having Common Partners:** An audit firm having a common partner or partners to the other audit firm as on the date of appointment, whose tenure has expired in a company immediately preceding the financial year, should not be appointed as auditor of the same company for a period of five years. [Example: Mrs. P, Mr. Q and Mr. R are the partners of M/s PQR & Co. Mr. R is also a partner M/s BCR & Co. Tenure of Mr. R has expired in the company immediately preceding the financial year. M/s BCR & Co. will also be disqualified for the same company along with M/S XYZ & Co. for the period of five years.]
- **Rotation for Other Prescribed Companies [Rule 5 of CAAR]:** The prescribed companies excluding one person companies and small companies are: (a) All unlisted public companies having paid up share capital of Rs. 10 crores and more; (b) All private limited companies having paid up share capital of Rs. 250 crores or more; (c) All companies having paid up share capital of below threshold limit but having public borrowings from financial institutions, banks or public deposit Rs. 50 crores or more. [Example: Saha Pvt. Ltd., a private limited Company with paid up share capital of Rs. 38 crores but public borrowing from nationalized banks and financial institutions of Rs. 56 crore are a prescribed company eligible for rotation.]
- **Time Period for Compliance for Existing Companies:** Every listed or prescribed companies existing on or before the commencement of this Act should comply with requirements of within a period which should not be later than the date of the first AGM of the company held, within the period specified u/s 96(1) after 3 years from the date of commencement of this Act. [Example: (a) Mr. Rahul is an individual auditor of Bishakha Ltd. for last 5 years as on March, 2013. He can continue the audit of the company up to the first annual general meeting to be held after 3 years from the date of commencement of the Act. (b) M/s Rahul Associates, a CA Audit Firm is auditing Ashoka Ltd. for last 11 years as on March, 2013. It can continue the audit up to the first AGM to be held after 3 years from the date of commencement of the Act.]
- **Right of Removal or Resignation not Affected:** Provisions of Section 139(2) do not prejudice the right of the company to remove an auditor or the right of the auditor to resign from the company.
- **Rotation of Auditors by Companies on Expiry of Term [Rule 6 of CAAR]:** The Central Government may prescribe the manner of rotation by the companies [u/s 139 (4)]. The Audit Committee (in companies where Audit Committee is required to be constituted) should recommend to the BOD the individual auditor/firm or of an audit firm who may replace the incumbent auditor on expiry of the term. The BOD should consider the recommendation of the committee, or make its own recommendation (in companies where Audit Committee is not required to be constituted) for appointment of the next auditor in AGM. For the purpose of the rotation of auditors: (a) the period for which the individual/firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of 5 consecutive years or ten consecutive years, as the case may be; (b) the incoming individual auditor/firm is not eligible if such auditor is associated with the outgoing auditor or audit firm under the same network of audit firms; (c) a break in the term for a continuous period of 5 years shall be considered as fulfilling the requirement of rotation; (d) 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, such other firm will also be ineligible to be appointed for a period of 5 years. Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors do not complete their term in the same year. [Note: (1) "Same network" includes the firms operating under the same brand name, trade name or common control; (2) The word "firm" shall include a limited liability partnership incorporated under the Limited Liability Partnership Act, 2008.]

#### *Rotation between Partners of Audit Firms [u/s 139(3)]*

Members of a company may resolve to provide that— (a) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or (b) the audit shall be conducted by more than one auditor.

#### *Subsequent Auditor of Government Company [u/s 139(5)]*

- **Appointment by CAG:** The Comptroller and Auditor-General (C&AG) of India should appoint a duly qualified auditor in a Government company in respect of a financial year. [Note: The provision of this sub-section is applicable for Government companies or any other companies is owned or controlled (holding more than 51% of the paid up share capital), directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments and includes a subsidiary of a Government Company.]
- **Time Limit for Appointment:** The appointment is to be made within a period of 180 days from the commencement of the financial year.
- **Tenure of Appointment:** The auditor should hold office till the conclusion of the AGM.

*First Auditor of Non-Government Company [u/s 139(6)]*

- **Appointment by BOD:** The first auditor of a company, other than a Government company, should be appointed by the BOD. [Example: The Managing Director (MD) of P Ltd. wants to appoint CA Tapas as the first auditor of the company. However, he is not eligible to so u/s 139(6) since the BOD appoints the first auditor of the company]
- **Time Limit for Appointment:** The appointment is to be made within 30 days from the date of registration of the company.
- **Consequences of Failure of BOD:** The BOD should inform the members of the company, who should within 90 days appoint such auditor at an Extraordinary General Meeting (EGM).
- **Tenure of Auditor:** The auditor should hold office till the conclusion of the first AGM.

*First Auditor of Government Company [u/s 139(7)]*

- **Appointment by CAG:** C&AG of India should appoint the first auditor in a Government company.
- **Time Limit for Appointment:** Appointment should be made within 60 days from the date of registration of the company.
- **Consequences of Failure of CAG:** If C&AG fail to appoint the auditor within 60 days, the BOD should appoint such auditor within the next 30 days. If BOD too fails to appoint such auditor within the next 30 days, it should inform the shareholders who should appoint such auditor within the 60 days at an EGM. [Example: The BOD of India PLtd., a Government company, appointed its first auditor within 60 days of its registration. However, the appointment should have been made by C&AG u/s 139(7). So, the appointment by the BOD is null and void.]
- **Tenure of Auditor:** The auditor should hold office till the conclusion of the first AGM.

*Filling of Casual Vacancy [u/s 139(8)]*

- **Non-Government Company:** Any casual vacancy should be filled by the BOD within 30 days. If the casual vacancy is due to the resignation by an auditor, the appointment should also be approved by the company at AGM within 3 months of the recommendation of the BOD and he shall hold the office till the conclusion of the next AGM. [Note: Casual Vacancy is the vacancy created due to death, resignation of the auditor or dissolution of audit firm.]
- **Government Company or Government Owned/ Controlled Companies:** Casual vacancy is filled up by the C&AG within 30 days. If C&AG fail to fill the vacancy within 30 days, the BOD should do it within next 30 days.

*Re-appointment of Auditor [u/s 139(9)]*

A retiring auditor may be re-appointed at an AGM, if— (a) he is not disqualified for re-appointment; (b) he has not given the company a notice in writing of his unwillingness to be re-appointed; and (c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

*Consequences of Failure to Appointment/ Re-appointment Auditor in AGM [u/s 139(10)]*

If no auditor is appointed or re-appointed in an AGM, the existing auditor should continue to be the auditor of the company.

*Recommendations of Audit Committee [u/s 139(11)]*

If the company is required to constitute an Audit Committee (u/s 177), all appointments and filling of a casual vacancy of an auditor under should be made after taking into account the recommendations of such committee.

[Note: Apart from public listed companies, all unlisted public companies having (a) paid-up capital of Rs. 10 crore or more; (b) turnover of Rs. 100 crore or more; and (c) outstanding loans, or borrowings, or debentures or deposits of Rs. 50 crore or more as on the date of last audited financial statements should constitute audit committee (u/s 177).]

[Example: ABC Ltd. with paid up capital of Rs. 8 crore and turnover of Rs. 120 crores is required to constitute an Audit Committee since the company falls under any one of the prescribed category.]

### **Removal, Resignation of Auditor Giving Special Notice [u/s 140]**

#### *Removal before Expiry of Term [u/s 140(1)]*

- **Resolution:** The auditor appointed (u/s 139) may be removed from his office before the expiry of his term by passing a special resolution after obtaining approval of the Central Government.
- **Process of Removal (Rule 7 of CAAR):** The application to the Central Government for removal should be made in Form ADT-2 with prescribed fees [Companies (Registration Offices and Fees) Rules, 2014] within 30 days of the resolution passed by the BOD. The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution.
- **Opportunity of being heard:** The concerned auditor should be given a reasonable opportunity of being heard before removal.

#### *Filing of Statements in Case of Resignation [u/s 140(2)]*

- **Duty of the Auditor:** The auditor who has resigned from the company should file a statement in Form ADT-3
- **Contents of the Statement:** The auditor should indicate in the statement, the reasons and other relevant facts with regard to his resignation.
- **Filing Authority:** The auditor should file statement with: (a) the company; (b) ROC; (c) CAGI [u/s 139(5)]
- **Time Limit for Filing:** The statement should be filed within 30 days from the date of resignation.
- **Consequences of non-compliance [u/s 140(3)]:** In case of non-compliance the auditor will be liable to a penalty which is lower of (a) Rs. 50,000; or (b) an amount equal to his/its remuneration. In case of continuing failure the auditor will be liable to further penalty of Rs. 500 for each day of failure after the first, subject to a maximum of Rs. 5,00,000. [As amended by Companies (Amendment) Act, 2019]

#### *Procedure for Removal [u/s 140(4)]*

- **Requirement of Special Notice:** Special notice is required for the following resolution at an AGM: (a) appointing as auditor a person other than a retiring auditor; or, (b) providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of 5 (individual) /10 years (firm) [u/s 139(2)].
- **Copy of Notice:** The Company should immediately send a copy of the notice of such resolution to the retiring auditor upon receipt.
- **Representation Received from Auditor:** With respect to the notice of such resolution, the retiring auditor makes a written representation (of a reasonable length) to the company and requests the company to notify it to the members.
- **Duty of the Company:** The company should: (a) state the fact of the representation having been made in any notice of the resolution given to members; and (b) send a copy of the representation to every member to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company unless the representation is received by the company too late to do the aforesaid.
- **Consequences of not Sending the Representation:** If a copy of the representation is not sent because it was received too late or because of the company's default: (a) the auditor may require that the representation be read out at the meeting; and (b) a copy thereof should be filed with the ROC.
- **Restrictions on the Auditor's Right of Representation:** If Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred to the auditor are being abused, the copy of the representation may not be sent and the representation need not be read out at the meeting.

#### *Directions for Change of Auditors [u/s 140(5)]*

- **Issuer of Directions:** The Tribunal may give directions for changes of auditors.
- **Timing of Issuance of Directions:** The Tribunal may issue such direction: (a) suo motu; or (b) on an application made to it by the Central Government; or (c) on an application made by any person concerned.

- **Circumstances of Issuing Directions:** The Tribunal may direct the company to change its auditors, if it is satisfied that the: (a) auditor has directly or indirectly acted in a fraudulent manner; or (b) abetted or colluded in any fraud in relation to the company or its directors or officers.
- **Appointment of Auditor by Central Government:** If the Tribunal is satisfied that a change of the auditor is required based on an application made by the Central Government, it should make an order to that effect within 15 days of receipt of such application and ask the Central Government to appoint another auditor in his place.
- **Disqualification of Auditor from Further Appointment:** An auditor (individual/firm) against whom final order has been passed by the Tribunal: (a) is not be eligible for appointment as an auditor of a company for a period of 5 years from the order date; and (b) is liable for action (u/s 447).

### **Eligibility, Qualifications and Disqualifications of Auditor [u/s 141]**

*Eligibility to be appointed as Auditor [u/s 141(1) and (2)]*

- **Individual:** Only a CA in practice is eligible for appointment as an auditor of a company.
- **Firm:** A firm whereof majority of partners practising in India are qualified for appointment in a company by its firm name. If a LLP is appointed as an auditor of a company, only the partners who are CAs are authorised to act and sign on behalf of the firm.

*Disqualification [u/s 141(3) and Rule 10 of CAAR]*

The following are not eligible for appointment as an auditor of a company: (a) a body corporate other than a LLP registered under the LLP Act, 2008 [u/s 141(3)(a)]; (b) an officer or employee of the company [u/s 141(3)(b)]; (c) a person who is a partner, or who is in the employment, of an officer or employee of the company [u/s 141(3)(c)]; (d) a person who, or his relative or partner (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company [u/s 141(3)(d)(i)] (**Check Note-1 and Example-1 to 4**); (ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of Rs. 5 lakhs [u/s 141(3)(d)(ii)] (**Check Note 2 and 3**); or (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for in excess of Rs. 1 lakh [u/s 141(3)(d)(iii)] (**Check Note 4**); (e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed [u/s 141(3)(e)] (**Check Note 5**); (f) a person whose relative is a director or is in the employment of the company as a director or KMP [u/s 141(3)(f)]; (g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies [u/s 141(3)(g)]; (h) a person who has been convicted by a court of an offence involving fraud and a period of 10 years has not elapsed from the date of such conviction [u/s 141(3)(h)]; (i) a person who, directly or indirectly, renders any service (u/s 144) to the company or its holding company or its subsidiary company [u/s 141(3)(i)] (**Check Note 6 and 7 and Example 5**).

### **Notes**

1. A relative of an auditor may hold securities in the company of face value not exceeding Rs. 1 lakh. If securities or interests are held beyond the limit, the auditor should take corrective action within 60 days of such acquisition or interest to maintain the limit.
2. It is immaterial that the credit period allowed to the auditor is allowed to all customers in the ordinary course of business
3. If an auditor recovers fees from the company on a progressive basis, even though the audit has not been completed, he cannot be said to be indebted to the company.
4. A relative means anyone who is related to another as members of a HUF; husband and wife; father (including step- father), mother (including step-mother), son (including step-son), son's wife, daughter, daughter's husband, brother (including step- brother), sister (including step-sister).
5. Business relationship shall be construed as any transaction entered into for a commercial purpose, except - (a) commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts; and (b) commercial transactions which are in the ordinary course of business of the company at arm's length price - like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.
6. Individual Auditor: either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant

influence or control, or whose name or trade mark or brand is used by such individual, will be termed as rendering of services directly or indirectly by the auditor

7. **Audit Firm:** either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners, will be termed as rendering of services directly or indirectly by the auditor.

#### Example

1. Mr. X, CA is holding securities of ABC Ltd. having face value of Rs. 800. He is ineligible to be appointed as an auditor of ABC Ltd. since he is holding a security in the company [u/s 141(3)(d)(i)].
2. Mr. Q, CA and Mr. R are relatives. Mr. R is holding securities of XYZ Ltd. having face value of Rs. 95,000. Mr. Q is not ineligible to be appointed as an auditor of XYZ Ltd., since his relative is holding security within the threshold limit of Rs. 1 lakh [141(3)(d)(i)].
3. M/s DE & Co. is an Audit Firm with Mr. D and Mr. E as partners. Mr. X is a relative of Mr. E. Mr. X is holding securities of PQR Ltd. having face value of 1,02,000. M/s DE & Co. is ineligible to be appointed as an auditor of PQR Ltd., since relative of one of the partners of M/s DE & Co. is holding security beyond the threshold limit of Rs. 1 lakh [u/s 141(3)(d)(i)].
4. M/s OP & Co. is an audit firm with CA O and CA P as partners. Pen Ltd. offered an appointment to the firm as an auditor for the FY 2017-18. Mr. C, a relative of CA. R, is already holding 6000 shares (face value of Rs. 10 each) in company. The current market value of the shares is Rs. 1,50,000. Since relative of a business partner is holding security with face value of Rs. 60,000 (6000 shares of Rs. 10 each) which is lower than the threshold limit of Rs. 1 lakh, the firm is eligible for appointment [u/s 141(3)(d)(i)].
5. CA. Q is providing investment banking services of D Ltd. The company offered CA Q to be appointed as an auditor for the current financial year. Since CA Q was directly providing investment banking services to the company, which is one of the prohibited services (u/s 144), he is disqualified to be appointed as an auditor in the company [u/s 141(3)(i)].

#### *Subsequent Disqualifications [u/s 141(4)]*

If a person appointed as an auditor of a company incurs any of the disqualifications after his appointment, he should vacate his office as such auditor it should be deemed to be a casual vacancy in the office of the auditor.

**Example:** M Ltd. in their AGM in September, 2017 appointed CA B as an auditor. CA B accepted the assignment. Later, in February 2018 CA D, who is the Finance Manager of M Ltd. joined him as a partner. CA B becomes disqualified to continue his office as an auditor of M Ltd. since his partner CA D is an employee of the organisation which is contravention of Section 141(3)(c). Hence, in compliance with Section 141(4), CA B should be deemed to have vacated the office of the auditor

#### **Ceiling on the Number of Audits [u/s 141]**

##### *Ceiling on Audit [u/s 141 (3) (g)]*

A person or a partner of a firm holding appointment as its auditor should not hold appointment as an auditor in more than 20 companies on the date of appointment. The company must obtain a certificate from the auditor to that effect before giving him the appointment. In computing the specified number of audit assignments: (a) the number of assignments, which he or any partner of his firm has accepted individually or in combination with any other CAs in practice or firm should be taken into account; (b) the number of partners of a firm on the date of acceptance of audit assignment should be taken into account; and (c) a CA in full time employment elsewhere should not be taken into account.

**Note:** While computing the limit of 20 appointments held in One Person Companies (OPCs), dormant companies, small companies and private companies having paid up share capital less than Rs. 100 crore which has not committed default in filling its financial statements (u/s 137) or annual return (u/s 92) of Companies Act with registrar shall not be considered [Notification No. G.S.R. 464(E) dated June 5, 2015].

##### *Specified Number of Firm*

In the case of a firm of auditors, 'specified number of companies' should be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere. If any partner of the firm CAs in practice is also a partner of any other firm or firms of CAs in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the specified number of audit assignments in the aggregate. If any partner of a firm or firms of CAs in practice accepts one or more audit assignments in his individual capacity, or in the name of his firm, the total number of such assignment that may be accepted by all firms in relation to such CA and by him should not exceed the specified number of audit assignments in the aggregate.



**Note: (a) This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be  $3 \times 20 = 60$  company audits; (b) Sometimes, a CA 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.**

*Specified Number as per ICAI Notification [Council General Guidelines, 2008 (Chapter VIII)]*

A CA in practice is deemed to be guilty of professional misconduct, if he holds at any time appointment of more than 20 audit assignments **(30 including OPC, dormant, and small companies and private limited companies with paid up capital less than Rs. 100 crore as per ICAI Notification)** of the companies **u/s 141(3)(g) [Part II (ii) Schedule II, Chartered Accountants Act 1949]**.

*Records of Audit Assignments*

A CA in practice as well as a firm of CAs in practice should maintain a record of the audit assignments accepted by him or by the firm or by any of the partner of the firm in his individual name or as a partner of any other firm as far as possible in the prescribed manner.

*Ceiling on Tax Audit Assignments*

An auditor, as an individual or as a partner of a firm can accept up to 60 tax-audit assignments **(u/s 44AB)**. A CA in practice will be deemed to be guilty of professional misconduct if he accepts more than this limit in a financial year **(ICAI Notifications)**.

### **Remuneration of Auditors [u/s 142]**

*Authority to Fix Remuneration*

The remuneration of the auditor of a company is fixed: (a) in its general meeting; or (b) in such manner as may be determined. Remuneration of the first auditor is fixed by the BOD.

*Composition of Remuneration*

The remuneration in addition to the fee payable to an auditor include: (a) the expenses incurred by the auditor in connection with the audit of the company; and (b) any facility extended to him. It does not include fee paid to him for any other service rendered at the request of the company.

*Disclosure Requirement*

The notes should contain detailed information regarding amount paid to auditor, whether as fees, expenses or otherwise for services rendered under the following heads: (a) As auditor; (b) For taxation matters; (c) For company law matters; (d) For management services; (e) For other services; and (f) For reimbursement expenses.

### **Powers/Rights of the Auditor**

*Rights of Accessing Books of Accounts and Other Information*

- **Books of Accounts [u/s 143(1)]:** Auditor has a right of access to the books of account and vouchers of the company kept at the registered office of the company or at any other place at all times.
- **Information and Other Explanation [u/s 143(1)]:** The auditor is entitled to require necessary information and explanation from the officers of the company for the performance of his duties as auditor.

**Notes: (a) Books include all usual/statutory/statistical/memoranda books (inventory books, costing records, etc.) which have or are likely to have a bearing on the accounts that are inspected by the auditor. Voucher includes all or any of the correspondence that may vouch for the accuracy of the accounts; (b) Officer includes any director/manager/KMP/ any person in accordance with whose directions or instructions the BOD or any one/more of the directors is/are accustomed to act [u/s 2(59)]; and (c) If the auditor is not provided with the required information for the performance of his duties or is denied access to books, etc., he should report to the members.**

*Right of Auditor of Holding Company [u/s 143(1)]*

The auditor of a holding company also has the right of access to the records of all its subsidiaries and associate companies in so far as it relates to the consolidation of its financial statements with those subsidiaries and associate companies.

*Right of Lien*

Auditor can exercise lien on books and documents at his possession for non-payment of fees by the client on account of work done on them. The Institute of Chartered Accountants in England and Wales

(ICAE&W) has expressed a similar opinion with the following conditions: (a) The retained documents must belong to the client who owes the money; (b) The documents should have come into possession of the auditor on the client's authority and not received through irregular or illegal means (e.g. in a company audit, the BOD must authorise such possession); (c) The auditor can retain the documents only if he has done the assigned work on the documents; and (d) Documents which are connected with the work on which fees have not been paid may be retained by the auditor.

**Notes:** (1) A person with lawful possession of someone else's property, on which he has worked, may keep the property for non-payment of his dues on account of the work done on the property. (2) A CA cannot exercise lien over client's documents/records for non-payment of fees (Ethical Standards Board, ICAI).

### **Duties of Auditor (u/s 143)**

#### *Inquire into Propriety Matters [u/s 143(1)]*

The auditor should inquire whether: (a) loans and advances on the basis of security are properly secured and the terms of such loan are prejudicial to the interests of the company or its members; (b) transactions of the company represented merely by book entries are prejudicial to the interests of the company; (c) shares, debentures and other securities of the company are sold at a price less than that at which they were purchased where the company is not an investment company or a banking company; (d) loans and advances made by the company are shown as deposits; (e) personal expenses are charged to revenue account; (f) cash has been received against a statement in the books and documents regarding allotment of shares for cash and even if cash has not been received, the position stated in books and balance sheet is correct, regular and not misleading.

**Note:** The auditor is not required to report on the matters specified in sub-section unless he has any special comments to make on any of the items referred to therein [Research Committee, ICAI]

#### *Reporting over Accounts and Financial Statements [u/s 143(2)]*

The auditor should report to the members of the company on the financial statements laid before the company in AGM. The auditor to the best of his information and knowledge should report whether the financial statements give a 'true and fair' view of the state of the company's affairs; profit/loss; and cash flow at the end of the FY. The auditor should report on other prescribed matters. The auditor should take into account the provisions of this Act, the ASs and SAs or any underlying rules or order [u/s 143(11)]

#### *Other Elements to be covered in Audit Report [u/s 143(3)]*

The auditor's report should also state whether: (a) he/she has sought and obtained all the information and explanations which to the best of his/her knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and its effect on the financial statements; (b) 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) the report on the accounts of any branch office of the company audited [u/s 143(8)] by a person other than the company's auditor has been sent to him; (d) the company's balance sheet and profit and loss account are in agreement with the books of account and returns; (e) the financial statements comply with the ASs; (f) the observations of the auditors on financial transactions having adverse effect on the functioning of the company; (g) any director is disqualified from being appointed [u/s 164(2)]; (h) any qualification relating to the maintenance of accounts and other related matters; (i) the company has adequate internal financial controls (IFCs) with operating effectiveness with reference to financial statements in place; and (j) the other prescribed matters.

**Notes:** (a) Reporting requirement on adequacy of IFCs w.r.t. financial statements shall not be applicable to an OPC/small company/ other private company with turnover less than Rs. 50 crore as per latest audited financial statements and aggregate borrowings from banks or financial institutions or anybody corporate at any point of time during the financial year less than Rs. 25 crore; (b) The provision is applicable for the F.Y. commencing on or after 1<sup>st</sup> April 2015 and the auditor may voluntarily include a statement for the F.Y.'s commencing on or after 1<sup>st</sup> April 2014 and ending on 31<sup>st</sup> March 2015 (MCA Circular dated 14.10.2014)

#### *Other Matters to be Included in Auditor's Report (Rule 11 of CAAR)*

The auditor's report should include their views and comments that whether: (a) the company has disclosed the impact of pending litigations on its financial position in its financial statement; (b) the company has made provision required under any law/ ASs for material foreseeable losses on long term contracts including derivative contracts; (c) there has been any delay in transferring the required amounts to the Investor Education and Protection Fund (IEPF) by the company.

#### *Reasons for Reservations [u/s 143(4)]*

The report should state the reasons for qualifications of the matters required to be included in the audit report.

#### *Provisions for Government Companies*

**(a) Directions by C&AG to the Auditor [u/s 143(5)]:** The auditor should submit a copy of the audit report to the C&AG including the directions issued by the C&AG and actions taken thereon and its impact on the accounts and financial statements.

**Notes:** C&AG appoints the auditor in a Government company or any other company owned/controlled, directly/indirectly by the Central/State Government or partly by the Central Government and partly by one/more State Government. [u/s 139(5) & (7) and direct the auditor the manner in which accounts of the company are required to be audited.]

**(b) Supplementary Audit [u/s 143(6)]:** The C&AG has a right to conduct a supplementary audit of the financial statement of the company by authorised person(s) and for the purpose of audit, require information to be furnished to the authorised person(s) for on directed matter within 60 days from the date of receipt of the audit report.

**(c) Supplementary Comment [u/s 143(6)]:** The C&AG have a right to comment upon or supplement the audit report.

**Notes:** Comments issued by the C&AG upon or supplement to the audit report are sent by the company to every person entitled to copies of audited financial statements [u/s 136(1)] and also placed before the AGM of the company at the same time and manner as the audit report.

**(d) Test Audit [u/s 143(7)]:** The C&AG may conduct test audit of the accounts of the company if he considers necessary or by an order and provisions of Sec. 19A of the C&AG's (Duties, Powers and Conditions of Service) Act, 1971 apply to the test audit report.

#### *Compliance with SAs [u/s 143(9) & (10)]*

**(a) Duty of the Auditor [u/s 143(9)]:** Every auditor should comply with the SAs.

**(b) Prescriptions by Central Government [u/s 143(10)]:** The Central Government may prescribe the SAs or any addendum thereto, as recommended by the ICAI constituted u/s 3 of Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority (NFRA).

**(c) Duty when SAs are not notified:** SAs specified by the ICAI are deemed to be used until any SAs are notified by the Central Government.

#### **Reporting on Other Matters [u/s 143(11)]**

The Central Government in consultation with the NFRA may direct a class or description of companies by general or special order to include a statement on other matters in the auditor's report.

**Notes:** Auditor is required to report on certain additional matters specified under Companies (Auditor's Report) Order (CARO), 2016

#### **Reporting of Fraud**

**(a) Reporting of Frauds of Rs. 1 crore or More [u/s 143(12)] and Rule 13 of CAAR]:** If an auditor of a company in the course of the performance of his/her duties has reason to believe that an offence of fraud involving an amount of Rs. 1 crore or above, is being or has been committed by its officers or employees, the auditor should report the matter to the Central Government within 60 days of his knowledge following the indicated procedure: (a) Auditor should forward his report to the BOD/Audit Committee (as the case may be) immediately after his knowledge of the fraud, seeking their reply within 45 days; (b) The auditor should forward his report and the reply of the BOD/Committee along with his comments thereon to the Central Government within 15 days of receipt of such reply; (c) If the auditor fails to get any reply from the BOD/Committee within 45 days, he should forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the BOD/Committee; (d) The report should be sent to the Secretary, MCA in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail confirming the same; (e) The report should be on the letter-head of the auditor containing postal address, e-mail address and contact number and be signed by the auditor with his seal and should indicate his Membership Number; (f) The report should be in the form of a statement as specified in Form ADT-4.

**(b) Reporting of Frauds of Rs. 1 crore or Less [u/s 143(13)]:** In case of a fraud involving lesser than Rs. 1 crore, the auditor should report the matter to the Audit Committee/ BOD (as the case may be) within

2 days of his knowledge specifying: (a) The nature of fraud with description; (b) Approximate amount involved; and (c) Parties involved.

**(c) Provision Applicable for Other Auditors [u/s 143(14)]:** The provisions of this section shall mutatis mutandis apply to: (a) Cost Accountant conducting cost audit (u/s 148); or (b) Company Secretary (CS) in practice conducting secretarial audit (u/s 204).

**(d) Penalty for Non-Compliance [u/s 143(15)]:** Auditor, Cost Accountant or CS in practice are punishable with a fine for non-compliance that may range between Rs. 1 – 25 lakhs.

**Notes:** The companies, whose auditors have reported frauds to the BOD/Audit Committee but not to the Central Government, should disclose the details of frauds in the BOD report specifying: (a) nature and description of fraud; (b) approximate amount of fraud; (c) parties involved if remedial action not taken; and (d) remedial action taken.

**Example:** The accounts executive of ABC Ltd. had entered Rs. 70 lakhs of fake invoices of credit purchase in the books and cleared the payments. The auditor should report fraud to the BOD/Audit Committee (as the case may be) within 2 days of his knowledge of fraud. The company is also required to disclose the same in BOD Report. The auditor is not required to report the Central Government as the amount of fraud is less than Rs. 1 crore.

### References

1. Basu, S. K. Auditing and Assurance. Pearson.
2. Tandon et al. Practical Auditing. S. Chand.
3. Companies Act 2013
4. Companies (Audit and Auditor) Rules, 2014
5. SAs issued by the ICAI
6. Garg, P. Auditing and Assurance. S. Chand.
7. Bansal, S. Auditing and Assurance. S. Chand.