PREFACE

In the curricular structure introduced by this University for students of Post Graduate degree programme, the opportunity to pursue Post Graduate course in Subjects introduced by this University is equally available to all learners. Instead of being guided by any presumption about ability level, it would perhaps stand to reason if receptivity of a learner is judged in the course of the learning process. That would be entirely in keeping with the objectives of open educaion which does not believe in artificial differentiation.

Keeping this in view, study materials of the Post Graduate level in different subjects are being prepared on the basis of a well laid-out syllabus. The course structure combines the best elements in the approved syllabi of Central and State Universities in respective subjects. It has been so designed as to be upgradable with the addition of new information as well as results of fresh thinking and analysis.

The accepted methodology of distance education has been followed in the preparation of these study materials. Co-operation in every form of experienced scholars is indispensable for a work of this kind. We, therefore, owe an enormous debt of gratitude to everyone whose tireless efforts went into the writing, editing and devising of proper lay-out of the meterials. Practically speaking, their role amounts to an involvement in invisible teaching. For, whoever makes use of these study materials would virtually derive the benefit of learning under their collective care without each being seen by the other.

The more a learner would seriously pursue these study materials the easier it will be for him or her to reach out to larger horizons of a subject. Care has also been taken to make the language lucid and presentation attractive so that may be rated as quality self-learning materials. If anything remains still obscure or difficult to follow, arrangements are there to come to terms with them through the counselling sessions regularly available at the network of study centres set up by the University.

Needless to add, a great part of these efforts is still experimental—in fact, pioneering in certain areas. Naturally, there is every possibility of some lapse or deficiency here and there. However, these do admit of rectification and further improvement in due course. On the whole, therefore, these study materials are expected to evoke wider appreciation the more they receive serious attention of all concerned.

Prof. (Dr.) Subha Sankar Sarkar
Vice-Chancellor

Seventh Reprint : November, 2017

বিশ্ববিদ্যালয় মঞ্জুরি কমিশনের দূরশিক্ষা ব্যুরোর বিধি অনুযায়ী মুদ্রিত।

Printed in accordance with the regulations of the Distance Education
Bureau of the University Grants Commission.

POST GRADUATE : COMMERCE
[M.Com.]

Paper - 19

Modules- 1 & 2

Auditing

: Course Writing :

Prof. Subhasish Karan

: Editing :

Sri Indrajit Dhar

Netaji Subhas
Open University

Post Graduate
Commerce
M.Com-19

Module 1

Module 2

Unit 1 ❐ Auditing

Structure

1.0 Objectives

After reading and studying this unit a learner should be able to :

- Understand the conceptual framework of auditing with reference to its nature, scope and process.
- Explain the objectives of auditing.
- Provide a relationship between accounting and auditing principles.
- Get ideas of various types of audit
- Analyse the extended meaning of audit and its philosophy.
- Evaluate audit as a social science.
- Describe the social objects of audit.

1.1 Introduction

The development of accounting system had necessitated the emergence of a new area, known as auditing. Accounting takes into consideration the measurement, recording and disclosure aspect of a transaction with the objective of giving various financial information through financial statements to the owners of a concern and also to the users, money lending institutions, regulators and other stakeholders. In doing so an accountant has to follow various rules, regulations, principles, statutes, standards, laws, bye-laws, customs etc. But for ensuring its true and fairness, adequacy of disclosure, appropriateness, transparency as regards the financial effects, reliability and acceptability an independent examination is needed and for that the process applied is termed as auditing. So auditing in its simple form can be claimed to have been originated almost simultaneously with the development of organised system of accounting. In the process of its evolution a number of socio-economic and technological events have influenced the course of developments of auditing. Industrial revolution as coupled with change in economic policy also have caused far-reaching changes in techniques, reporting standards of the financial information which in turn has added a new dimension in the status and responsibility of the auditors. Again, with the advent of computers the method of processing information has completely changed. As a result the auditors has been forced to change their approach to auditing and now in a computerised environment the auditor has to place mo Cre emphasis on evaluation of systems, procedure, controls and on analytical procedures. Further the emergence of corporate governance and its compliance has created monumental importance to the subject of auditing. Besides, because of the change in attitude towards social responsibility from mere profit earning motive of the business houses the vision of the auditors has also changed to include in its purview the social and environment aspects of economic activities for sustainable developments of the society. So keeping in view all these aspects the fundamental and basic aspects of auditing including its social objectives is discussed in this unit.

1.2 Nature, Scope and Audit Process

Auditing relates to verification of accounting and financial data with a view to reporting on the reliability of financial statements. It has generally been associated with only accounting and financial records. This verification of data involves a careful evaluation of evidence, both internal and external, either available or which an auditor collects, obtains during the course of audit. According to Mautz "Auditing is concerned with the verification of accounting data for determining the accuracy and reliability of accounting statements and reports." The emphasis is to clearly on the verification of accounting data for the purpose of making an opinion and to the reliability and acceptability of the accounting and financial statements.

The scope of audit of financial statements is determined with reference to the terms of engagement, the requirement of the relevant legislation and the various pronouncements of the Institute of Chartered Accountants of India (ICAI). For forming an opinion all aspects of the enterprise to be concerned as far as they are relevant to the financial statements being audited.

As per Auditing and Assurance Standard (AAS) 1 of the ICAI "An audit is the independent examination of financial information of any entity whether profit oriented or not and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon". So, as per the definition an audit consists of the following :

- Competent independent person.
- Examination of financial information which encompasses financial statements.
- Entity—may be business entity or other concern like school, college, library, charitable trust owned privately or by the Government and created as per any law, act etc.
- Expression of opinion through the medium which is called audit report.

So, it is clear that auditing process involves evaluating the reliability, relevance and adequacy of evidence in support of the varifiable financial information.

The industrial growth because of new liberalised economic policy has again extended the scope of auditing remarkably. Now auditing is no longer concerned only with financial information it also involves review of compliance with law, costing records, operations and managing performances. It is important to mention here that scope of an audit in relation to matters prescribed by law or by any pronouncements of the ICAI cannot be restricted by the appointing authority through terms of engagements.

Auditing is thus a process by which competent individuals collect and evaluate evidence to form an opinion and communicate his opinion to various interested persons through his audit report. So, the auditing process involves the following components :

- Auditor
- Books of Accounts / Records / Statement
- Auditing procedure / practices

Auditors in India are the practising chartered Accountants who are legally competent to conduct auditing.

Books of Accounts which are prepared by an entity in accordance with the Generally Accepted Accounting Principles (GAAP) covering accounting standards, requirements of companies act and other relevant acts and related laws.

Auditing procedure implies the standard methods, systematic way by which the audit work should be conducted for discharging the responsibility effectively and assuring best quality services. In India the ICAI issues time to time standard auditing practices which is called ‘‘Auditing and Assurance Standards’’ (AAS) which an auditor must comply whenever an audit work needs to be carried out.

1.3 Objective of audit

The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable the auditor to obtain sufficient audit evidence on which to base his independent opinion on the financial statements being audited. In the case of an audit under statute, the auditor must comply with all the duties laid upon him by the relevant statute, and in the case of private audits he must fulfil all the terms of his agreements with the client. In particular, it must be recognised that auditors have duties in relation to the prevention and detection of fraud and error. Where an auditor fails to discover a fraud or error which should have been brought to light by sound auditing technique he could be held to be liable for negligence. Under modern conditions, organisations have also to promote public interest, discharge social responsibilities rather than only looking into the private gain of the investors for all round development of the society which need to be ensured by the auditor in the course of audit.

Thus the objectives of an audit are :

A. Independent review of the financial statesments and making of opinion towards its true and fairness :

The Auditing and Assurance Standard 2 (AAS 2) describes the overall objective and scope of the audit of general purpose financial statements of an enterprise by an independent auditor. According to this standard the objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements which in turn help determination of the true and fair view of the financial position and operating results of an enterprise. The auditor is responsible only for forming and expressing an opinion on the financial statements while the responsibility of its preparation lies on the management of the enterprise including maintenance of adequate accounting records and internal controls, the selection and application of accounting policies and the safeguarding of the assets of the enterprise. It is also important to mention here that the auditor's opinion is not an assurance to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

B. Responsibility towards fraud and error :

Auditing and Assurance Standard 4 (AAS 4) on ''The auditor's responsibility to consider fraud and error in an audit of financial statements'' discusses the auditor's responsibility with respect to fraued and error in an audit of financial statements. The primary responsibility for the prevention and detection of fraud and error rests with both those charged with governance and the management of an entity. Auditor's responsibility is to express an opinion on financial statements. An audit must be conducted in accordance with the auditing standards generally accepted in India providing reasonable assurance that the financial statements taken as a whole are free from material misstatements whether caused by fraud and error. In forming his opinion on the financial statements the auditor must follow the procedures which is designed to satisfy himself that the financial statements reflect or exibit a true and fair view of the financial position and operating results of the enterprise. Because of the test nature and other inherent limitations of any system of internal control the auditor should consider the risk of material misstatements in the financial statements resulting from fraud or error at the time of planning and performing audit procedure and evaluating and reporting the results thereof. So there is a possibility that some material misstatement may remain undiscovered and such risk cannot be avoided completely. The discovery of the material misstatement is not the main objective of audit nor is the auditor's work programme specifically designed to such discovery. But if the auditor has any indication that some fraud or error may have accurred which could lead to material misstatement, the auditor should extend his porcedures to confirm or remove his suspicious. The fact that an audit which is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

C. Social and other specific responsibility :

In forming and expressing an opinion on the financial statements the auditor as a responsible citizen must take into consideration social aspects of audit giving due emphasis on the points that the enterprises are discharging their social responsibilities properly without making any harmful effect on the society it belongs. Like other branches of social science an audit must always have some social objectives.

The audit besides independent financial audit, may encompass such other areas like review of operations, effectiveness of management policies, cost records and so on. Accordingly there will be specific objectives in respect of each type of specific audits.

It is also the objective of an auditing to provide spin-off effects. The auditor sometimes assist his clients to solve various accounting, taxation, financial and other problems.

1.4 Relationship between Accounting and Auditing Principles

Accounting principles are general decision rules derived from the accounting concepts. It influences the development of accounting techniques which are specific rules to record specific transactions and events in an organisation. The end product of every accounting system is the financial statements containing financial information of an entity. In preparing and presenting the financial statements it is essential to consider the following accounting principles :

1. Cost Principle
2. Revenue Principle
3. Matching Principle
4. Objectivity Principle (Verifiability Principle)
5. Consistency Principle
6. Full disclosure Priciple
7. Conservatism Principle
8. Materiality Principle
9. Uniformity and Comparability Principle.

As stated earlier an audit is the independent examination of financial statements of an entity, whether profit oriented or not, and irrespective of its size or legal form, with a view to express an opinion about the true and fairness of the financial information contained therein. An auditor while examining the financial statements have generally assured that all the fundamental accounting principles have been duly complied with in preparation and presentation of the same. So all these accounting principles are equally important to an auditor also and he must have adequate knowledge and clear understanding of it which will facilitate to discharge his professional liabilities properly. The accounting principles, compliance of which is verified in every audit process, may be considered as the basic foundation based on which financial statements are prepared ensuring its reliability, quality, acceptability and usefulness. So there exists a strong interrelationship between accounting and auditing principles.

Moreover as per AAS 1 issued by ICAI on "Basic principles governing an audit" the following are the basic principles of auditing which govern the auditor's professional responsibility and should be complied with whenever an audit is carried out.

1. Integrity
2. Objectivity and independence
3. Confidentiality
4. Skills and competence
5. Planning
6. Documentation
7. Audit evidence
8. Accouting System and Internal Control
9. Work performed by others.
10. Audit conclusion and reporting.

1.4.1 Integrity

Integrity requires that the auditor should be straight forward, honest and sincere in his professional duty. Integrity is subjective and cannot be standarised by making law or by setting standards. While conducting an audit he should maintain an impartial attitude and appear to be free of any interest, so that society do not doubt his integrity.

1.4.2 Objectivity and independence

In the performance of any professional service, the auditor should maintain objectivity and independence.

Objectivity means in reporting and working on any professional work he shall not be influenced by his personal whims and fancies or by other's directions. He should give his opinion based on facts, situation and as per generally accepted auditing principle.

Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him or to his own self-interest.

1.4.3 Confidentiality

The auditor should maintain the confidentiality of information acquired in the course of his work. He should not disclose such information to a third party without specific permission of the client or unless there is a loyal requirement of professional duty to disclose.

1.4.4 Skills and competence

The audit must be performed and the report should be prepared with due professional care by persons who are having adequate training, experience, competence and have attained technical standards. The Institute of Chartered Accountants of India conducts continuing professional education for its members to keep them abreast of recent developments enhancing the quality of auditor.

1.4.5 Planning

The auditor should plan his work covering the following among other theories, which enables him to conduct an effective audit timely and efficiently.

- Acquiring the knowledge of client's business
- Acquiring the knowledge of client's accounting system, policies and internal control procedure
- Determining the degree of reliance of the internal control system and fixing up the extent of checking
- Formulating the audit programme.

1.4.6 Documentation

The auditor should maintain systematically the documents created or collected for various matters during the course of audit. It is important as it provides evidence in future that the audit was carried out in accordance with the basic principles.

1.4.7 Audit Evidence

The auditor should obtain sufficient and appropriate audit evidence by compliance and substantive procedure which enable him to make perfect opinion on the financial statements.

Compliance procedures are tests designed to have reasonable assurance that the internal control system depending on which the audit programme is formulated are in effect.

Substantive procedures are tests of details of transactions, balance and include analysis of significant ratios and trends with a view to obtain evidence as regards completeness, accuracy and validity of the data produced by the accounting system.

1.4.8 Accounting system and internal control

Management is responsible for preparation of financial statements of an entity for which an adequate accounting system should be maintained involving various internal controls commensurate with the size and nature of the business. The auditor must ensure himself that internal control system is adequate providing assurance that all the accounting information which should be recorded has really been recorded. Extent of substantive procedure mainly depends on accounting system and internal control. It becomes less extensive if there is good accounting system and strong internal control system otherwise it will be more extensive.

1.4.9 Work performed by others

In the course of audit the auditor has to delegate work to assistants and also has to consider works performed by other auditors. In all such cases the auditors cannot escape the liability arising out of expression of opinion on the financial statements on the pretex that he delegated the work to others or used the work done by others. He, therefore, should carefully direct, supervise and review the work delegated to others and obtain reasonable assurance that works performed by other auditors and experts is adequate for his perpose.

1.4.10 Audit conclusion and reporting

The end product of every audit process is audit report through which auditor expresses his opinion about the financial statements of an entity.

The auditor's conclusion and reporting should be based on the audit evidence obtained and generally includes as to whether :

(a) The financial statements are prepared on the basis of generally accepted accounting principles and the same is applied consistently.

(b) The financial information complies with relevant laws and regulations.

(c) There is adequate disclosure of all material facts.

The audit report should contain a clear expression of opinion made on the financial information and it must be drawn in conformity with the requirements of the specific statute, agreement or regulation.

The audit report may contain following types of opinion :

(i) unqualified or clean opinion

(ii) qualified opinion

(iii) adverse opinion

(iv) Disclaimer of opinion

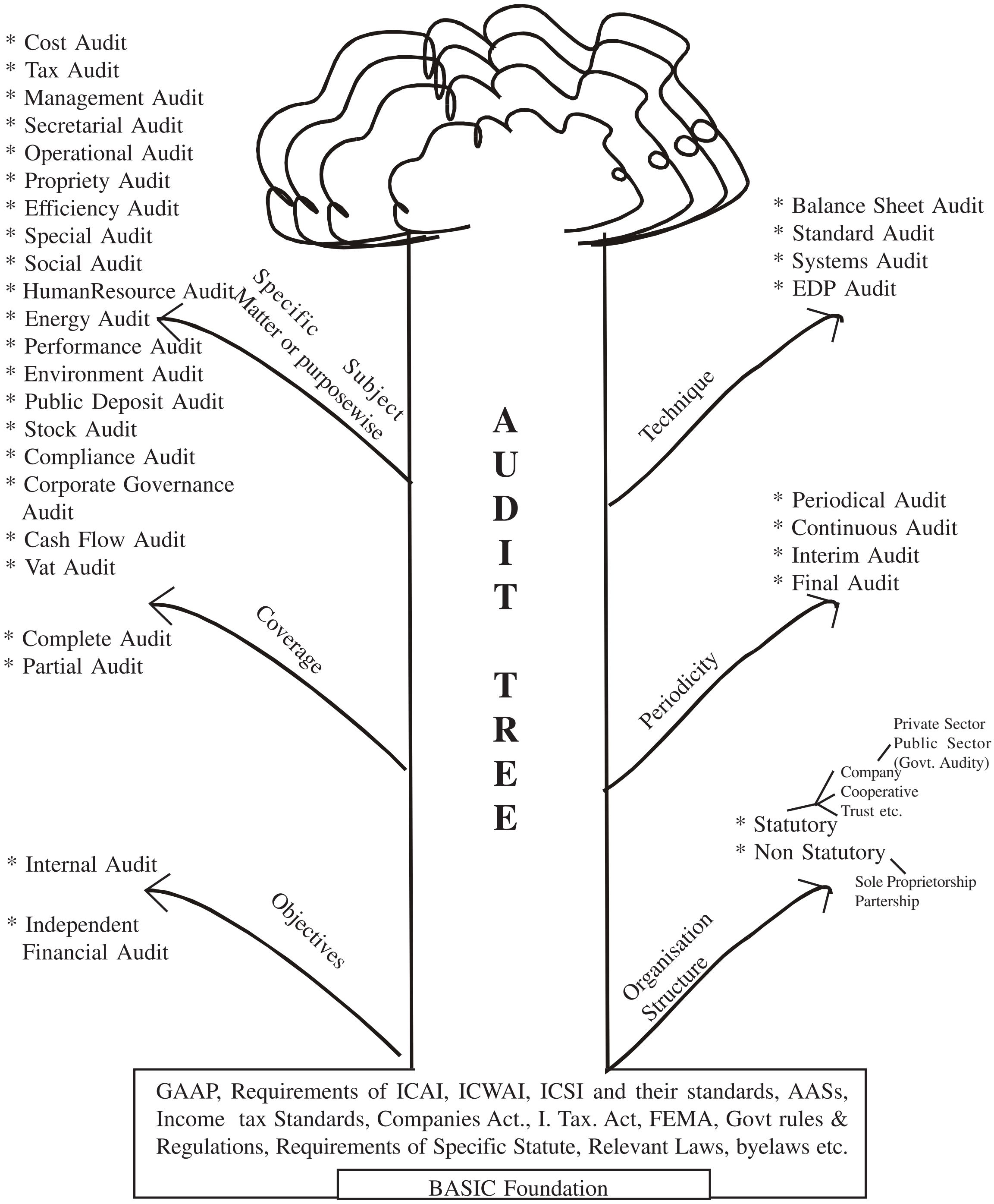
In case of qualified, adverse and disclaimer opinion the audit report should state the reasons for forming such opinion.

1.5 Types of audit

Classification of audit may be done on various basis and on such classification different types of audit are noticed. The total picture about basis and different branches of audit can be shown with the help of a tree may be called as "Audit Tree"

1.5.1 Periodical audit

Periodical audit means an audit which is done at the end of a specific period that may be quarterly, half-yearly or yearly but only after periodic finalisation of accounts. In this case


* Cost Audit
* Tax Audit
* Management Audit
* Secretarial Audit
* Operational Audit
* Propriety Audit
* Efficiency Audit
* Special Audit
* Social Audit
* HumanResource Audit
* Energy Audit
* Performance Audit
* Environment Audit
* Public Deposit Audit
* Stock Audit
* Compliance Audit
* Corporate Governance Audit
* Cash Flow Audit
* Vat Audit
Specific Matter or purposewise
Subject
* Complete Audit
* Partial Audit
Coverage
* Internal Audit
* Independent Financial Audit
Objectives
A U D I T T R E E
* Balance Sheet Audit
* Standard Audit
* Systems Audit
* EDP Audit
Technique
* Periodical Audit
* Continuous Audit
* Interim Audit
* Final Audit
Periodicity
Private Sector
Public Sector
(Govt. Audity)
Company
Cooperative
Trust etc.
* Statutory
* Non Statutory
Sole Proprietorship
Partership
Organisation Structure
GAAP, Requirements of ICAI, ICWAI, ICSI and their standards, AASs, Income tax Standards, Companies Act., I. Tax. Act, FEMA, Govt rules & Regulations, Requirements of Specific Statute, Relevant Laws, byelaws etc.
BASIC Foundation

the audit is commenced and completed in a single uninterrupted session with no chance of any collusion between audit staff and the clients staff and without any dislocation of clients work. Final audit is also known as periodical audit as it refers to a situation where the audit work is commenced only after the expiry of the period to be covered by the audit. Periodical audit is economical and very much convenient and useful for business houses which are small.

1.5.2 Interim audit

An interim audit is that kind of audit which is conducted for a part of the accounting year with some interim purpose. It involves an audit of the financial statements or other data relating to only a part of the accounting year and is generally conducted between two periodical or regular audits. The purpose for which interim audit is conducted may be :

(1) Declaration of interim dividend

(2) Submission of accounts for a specific purpose as required by any authority.

(3) For the disclosure of periodic financial information in compliance with any statutory requirements-

(4) For obtaining assurance as regards adquacy of internal control system in the organisation before starting its final audit.

Advantages :

(i) It facilities timely completion of final audit.

(ii) Error and fraud can be detected more quickly.

(iii) It helps in carrying moral check on the staff of the client.

(iii) It is very much helpful when publication of interim financial information become necessary.

1.5.3 Continuous Audit

According to Spicer and Pegler, "a continuous audit is one where the auditor's staff is occupied continuously on the accounts the whole year round, or where the auditor attends at intervals, fixed or otherwise, during the currency of the financial year, and performs an interim audit; Such audits are adopted where the work involved is considerable, and have many points in their favour, although they are subject to certain disadvantages."

According to R.C. Williams "a continuous audit is one where the auditor, or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or his staff attends the clients offices at regular or irregular intervals during the period."

A continuous audit, thus, is an audit which involves examination of accounts throughout the year at regular or irregular intervals. It is necessary for big business houses and not for small concerns where accounts can be audited at the close of the financial year when they are ready.

Continuous audit is suitable in the following cases :

(a) where final accounts are desired to be presented just after the close of the financial year, as in the case of a bank.

(b) where the transactions are many in number and it is considered necessary to get them audited at regular intervals.

(c) where the internal check system is not satisfactory.

(d) where after every month or quarter the statement of accounts are prepared and required to be presented to the management.

(e) where sales affected are very high.

Advantages

(1) As the auditor visit his client's office at regular interval a detailed close and exhaustive checking can be possible.

(2) The auditor checks the accounts in a detailed manner at regular intervals. It is thus possible for him to detect errors and fraud, easily and quickly.

(3) Since the accounts are checked round the year. It becomes possible to present the final audited accounts to the shareholders immediately after the end of the financial year. Thus, the work of the auditor becomes more efficient.

(4) Frequent visits by the auditor to the client's office makes the client's staff regular. The accounts they maintain become up-to-date and more accurate.

(5) Sometimes the auditor also pays surprise visits to the client's office which results in a moral check on them as these employees are not aware when the auditor will come. They will have to update their book regularly to avoid harrasment.

(6) The auditor keeps himself in touch with the business affairs and its technical details regularly. It helps him to provide valuable suggestions to his clients for improving the working of the business and the system of maintaining accounts.

(7) In big business houses where monthly statements are prepared continuous audit has proved to be very useful.

Distinction between continuous audit and interim audit—

(1) In the case of continuons audit, the work of audit is carried on for the whole financial year while in the case of interim audit, the audit work is done only up to a certain date involving a part of the financial year.

(2) In the case of continuous audit the preparation of trail balance is not necessary at intervals but in the case of interim audit it is prepared.

(3) Verification of assets and liabilities, in the case of continuous audit, is done at the close of the accounting year while the same is done, in the case of interim audit, at the time of audit.

(4) In the case of continuous audit the auditor submits his audit report at the close of the accounting year whereas in the case of interim audit report is submitted immediately after completion of the audit.

(5) In the case of continuous audit since the auditor's staff remains present in the client's office throughout the year it causes inconvenience to the staff of the client while interim audit does not have such problem.

1.6 Extended meaning of audit

The auditing profession now acknowledges that the public has now come to expect more of the auditor than mechanically drafted reports on financial statements. As a result modern concept of audit goes much beyond the statutory requirements to include audits like Environment Audit, Human Resource Audit, Social Audit, Energy Audit etc. in its perview.

1.7 Philosophy of audit

The services provided by an auditor may not be directly needed for the day to day operation of the business but he is concerned with appraisal, interpretation, analysis and valuation. It should not be assumed that he is a professional appraiser, analyst or valuer. However, the auditor is statutorily and / or morally responsible to protect and look into the interest of various parties who are directly or indirectly associated with the entity and interested in knowing the financial information with respect to that. He, therefore, has to appraise and certify the accuracy of various statements as well as to examine the financial statements with a view to express an opinion thereon in respect of its true and fairness keeping in view the requirements of law and generally accepted accounting principles. Modern concept of audit goes much beyond the statutory requirements. The modern auditor must be a talented individual who has the ability to make vital decisions on many important issues, and the courage and depth of character of stand by personal convictions. The auditing function offers individuals an opportunity that is rare in other fields of endeavor—that is, the opportunity, on almost a daily basis, to be responsible for making decisions and judgements as to what is right and what is wrong, and to stand by these decisionas and judgements regardless of the pressures that may be brought to bear. This opportunity has attracted many outstanding individuals to the field of auditing and has helped to retain them.

1.8 Auditing as a Social Science

Any branch or class of knowledge which directly of indirectly provides services to the society is called social science. All classes of knowledge are, in fact, social science. Accounting and auditing plays a vital role in ensuring steady economic growth of a country. Adequate and globally accepted accounting system and control through standard auditing practices helps a country in achieving his expected economic growth. It is important both at micro and macro level. And, because of its social implication and importance, it is influenced by law and governmental action. Introduction of companies Act and its amendment from time to time more specifically the sections 233A, 233B, 227 (1A) and 227 (4A) of the Companies Act may be cited as the glaring examples of government action on accounts and audit keeping in view the needs, benefits of the society. With globalisatioin the society's expectation from the profession of accountancy and auditing has also increased remarkably. Thus accounting and auditing may be considered as a social science.

1.9 Social Objects of Audit

The accountancy profession has to play an important role in the society. A distinguishing mark of this profession is acceptance of its responsibility to the public. The accountancy profession's public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community and others who rely on the objectivity intergrity, and independence of professional accountants to maintain the orderly functioning of commerce. The reliance imposes a public interest responsibility on the accountancy profession. The public interest is defined as the collective well-being of the community of people and institutions the professional accountant serves. Professional accountants hold important position and get highest status because they provide continuously the public with unique professional services at a level which demonstrates that the public confidence is firmly founded.

1.10 Questions

1. Define an audit and state its objectives.
2. Describe the basic principles of auditing.
3. State the relationship between accounting and auditing principles.
4. How do you classify an audit.
5. Distinguish between continuous and interim audit.
6. Write short notes on the following :
   (a) Social objects of audit
   (b) Philosophy of audit.
7. "Auditing is a social science"—comment.

Unit 2 ❐ Planning and Programming of Audit

Structure

2.0 Objectives

After reading and studying this unit, the learner should able to

- Describe the elements, need, factors considered in the planning phase of the audit.
- State the feature of audit checklist.
- Know the concept of audit notes and audit working papers and their importance.
- Assess the extent of reliance that may be given on internal auditor, experts and other auditor and incidence of responsibility.

2.1 Introduction

This unit describes the matters an auditor considers in planning an audit. It explains the concept of audit notes and audit working papers and their usefulness. An auditor is generally required to depend on reports given by other auditors in respect of the enterprise under audit and sometimes he also takes advice from the experts in other fields. All these aspects have been considered in this unit systematically keeping in view the requirements of the relevant auditing and assurance standards.

2.2 Audit Planning

In order to conduct an audit effectively and efficiently, the work needs to be properly planned and controlled. The way in which the audit is conducted will vary depending on the type, size and circumstances of the particular client.

As per AAS-8, Audit Planning refers to the planning made by the auditor which enables him to conduct an effective audit in an efficient and timely manner.

AAS-1 prescribes planning as one of the basic principles of auditing which govern the auditor's professional responsibilities in carrying out the audit.

2.2.1 Need for planning

According to this standard, adequate audit planning helps to ensure that:

a) Appropriate attention is devoted to important areas of the audit.
b) Potential problems are promptly identified.
c) Work is completed timely.
d) Assistants are utilised properly.
e) Proper coordination of work done by other auditors and experts.

2.2.2 Steps/Elements of planning

Audit planning involves the following steps:

i) Developing the overall plan.

In developing the overall plan for the expected scope and conduct of the audit the auditor should consider the following matters:

- The terms of his engagement and any statutory responsibilities.
- Nature and timings of the report.
- The applicable laws and statutory requirements.
- The nature and extent of audit evidence to be obtained.
- Degree of reliance he expects to place on internal control system.
- Scope and work of internal auditor.
- The accounting policies adopted by the client and changes in those policies.
- The allocation of work to be undertaken by joint auditors.
- The involvement of experts.
- Establishing and coordinating staffing requirements.
- Setting of materility levels etc.

ii) Acquiring knowledge of the client's accounting systems, policies and internal control procedure.

iii) Obtaining knowledge of client's business. The auditor needs to obtain a level of knowledge of the client's business for efficient conduct of an audit. It helps him to make judgement about the financial information. He can acquire the knowledge about client's business from the following sources:

- Client's annual report to shareholders.
- Minutes of the shareholders, Boards of directors and other important committees.
- Discussion with clients.
- MIS Report.
- Previous year's audit working papers.
- Accounting manual and procedure manual.
- Visit to client's premises and plant facilities.
- Internal auditor's report.

Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry, publications, trade journals, magazines, newspapers, text books.

iv) Developing the audit programme

An audit programme contains the details of audit procedure that are needed to impliment the audit plan. It mentions the steps which are to be carried out in conducting the audit including the name of the staff who will conduct the audit. It helps in controlling the execution work and specifies the following matters:

- Area of audit.

- Extent of checking.
- Details of staff with their assignments.
- Projected hours for the work.
- Checklist for audit procedure of different items.
- Checklist of auditing standards.
- Physical varification of various assets.
- Confirmation of balance and other methods of audit evidence.
- Experts to be coordinated.
- Partner in charge of the audit.

Checklist for statutory, legal compliances etc.

v) Review of the plan

The audit plan should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

2.2.3 Factors to be considered in planning an audit

The auditor may discuss the elements of his overall plan and certain audit procedure with the client to conduct the audit most efficiently and also to coordinate the audit procedure with the work of the client's personnel. In planning the audit, the auditor should consider factors such as complexity of the audit, the environment in which the enterprise operates, his previous experience with the client and knowledge of the client's business.

2.3 Audit Notes

During the course of audit the auditor has to come accross several difficulties or new points which may require discussion with the senior officials of the entity/client. Audit notes represents within record of the question made and replies required thereto. This may be of great help to the auditor preparing his audit report. If notes have been properly made through the books known as "Audit Note book", it may of great value to the auditor later on, in case a suit is filed against him for negligence or misfeasance. These notes will be considered as documentory evidence in favour of the auditor even after several years by which time the auditor might have forgotten everything about that particular audit. These notes should be clear, concise and complete so that it facilitate the audit of the accounts of the same concern next year. Some of the important matters which are noted down in an Audit Note Book are given below :-

1. List of Books of Accounts maintained by the client.
2. The points which requires further clarification and explanations.
3. Particulars of missing vouchers.

4. Mistakes and errors discovered.
5. The points which will be incorporated in the audit report.
6. Any matters which requires further discussion with the appropriate authorities.
7. Details of non-compliance, if any, as regards AS, Companies Act and other statutory and legal requirements.
8. observation towards physical verification of fixed assets and inventories.

2.4 Working Papers

Working papers are records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement. For auditors to conduct their audit properly and provide adequate support for their opinion, they must prepare audit working papers.

Although the term working papers suggests paper document, much audit evidence now exists in electronic files. A number of accounting firms are now developing paperless auditing systems. The term working papers is used here to include all audit documentation, both electronic and paper.

AAS-1, Basic Principles governing an audit, requires that the auditor should document matters which are important in providing evidence to ensure that the audit was carried out in accordance with the basic principles. So, their standard requires that the auditor must maintain adequate working papers.

AAS-3, Documentation, deals with the need, design, preparation, contents and custody of working papers and provides the following.

2.4.1 Need and importance

Audit working papers constitute the auditor's evidence of the work performed. They may be either helpful or detrimental if problems subsquently arise concerning the audited financial statements. They will become the most important documents envolved in any subsequent litigation. It facilitates supervision and review of the audit work and helps in planning and performance of the audit.

2.4.2 Design and preparation of working papers

Working papers should be properly designed and arranged so that it can meet the circumstances of each audit and the requirements of the auditor in respect thereof. The organisation of working papers in a standarised manner enhances the efficiency with which they are prepared and reviewed. Working papers should contain sufficiently complete and detailed information to facilitate an auditor to obtain an overall understanding of the audit. Although the extent of documentation is a matter of professional judgement but it is to be ensured that all significant matters which require the exercise of judgement, together with the auditor's conclusion thereon, must be included in the working papers.

2.4.3 Contents of working papers

Working papers should state

(a) Nature of engagement.

(b) Client's name.

(c) nature and complexity of the client's business.

(d) Sources of information.

(e) Form of the auditor's report.

(f) Nature and condition of the client's records.

(g) Degree of reliance on internal control.

(h) Supervision and review of work performed by assistant.

(i) Conclusions reached.

2.4.4 Types of working papers

Auditors normally maintain two types of working paper files one is referred to as a permanent or continuing audit file, and the other one is called current audit file.

Permanent audit file

The permanent audit file is composed of documents, schedules, and other data that will be of continuing significance to several years' audit. It generally includes the following :–

- Memorandum and article of association of the company.
- Extracts from or copies of important legal documents, agreements and minutes relevant to the audits on an ongoing basis.
- Record of study and evaluation of internal control.
- Record of communication with the previous auditor, if any.
- Copies of letters issued by the auditors to the management as regards weaknesses of internal control along with suggestions for improvement.
- Copies of audited financial statements of the previous year.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

Current audit file

The current audit files for each year contain the evidence gathered and the conclusions reached in the audit for that year. It normally includes the following -

- Correspondence relating to acceptance of annual appointments.
- Extracts of the minutes of board of directors and general meeting which are relevant to the audit.
- Audit programme.
- Evidence that work performed by the assistants was supervised and reviewed.
- Communication with client regarding audit matter.
- Letters of representation and confirmation from clients.
- Conclusions reached about significant aspects of audit.
- Copies of the financial information being reported on and the related audit reports.

Ownership and custody of working papers

Working papers prepared by an auditor in connection with the audit of a client's financial statements are generally the property of the auditor. Auditor may at his discretion can make the working papers available to his client. Unauthorised access to working papers must be prevented to maintain confidentiality of client's business.

2.5 Reliance on the work of an internal auditor

AAS-7, "Relying upon the work of an Internal Auditor", provides guidance as regards the procedures which should be applied by the external auditor in assessing the work of the internal auditor for the purpose of placing reliance upon that work.

This standard states that while the external auditor has the sole responsibility of his report however, much of the work of the internal auditor may be useful for the determination of the nature, timing and extent of the auditing procedure required in this examination of financial information.

The external auditor evaluates the internal audit function to the extent he considers necessary for the determination of the nature, timing and extent of his compliance and substantive procedure.

General evaluation of the internal audit function will assist the external auditor for determining the extent of reliance upon the work of the internal auditor. But the most important thing is that the responsibility of external auditor is not reduced by any means because of the reliance he places on the internal auditor's work. The external auditor should document his evaluation and conclusions in this report. In this context the important factors which must be considered by the external auditor are;

a) Organisational status.
b) Scope of function.
c) Technical competence.
d) Due professional care.

2.6 Reliance on the work of an expert

AAS-9, "Using the work of an expert", states the responsibility of an auditor in relation to, and the procedures the auditor should consider in, using the work of an expert as audit evidence.

The auditor while performing the audit work sometimes uses the work performed by the expert and also takes into account if necessry, the views of the expert in forming and expressing his opinion on the financial statement. However, he will be entitled to rely on worked performed by other auditors and experts provided he exercises adequate skills and care as is stated in AAS-1.

2.6.1 Evaluating the work of an expert.

The auditor should evaluate the work of an expert before acquiring it as audit evidence with reference to the following points:

- Professional qualification of the expert.
- Independence and objectivity of the expert.
- Experiance and reputation of expert.
- Expert's relationship with the client, if any.
- Assumptions/Method used by the expert on deriving the conclusion.
- Result of the expert's work in the light of auditor's overall knowledge of the business.

2.6.2 Auditors liability towards the use of work performed by an expert.

The auditor is entitled to rely on the work performed by the expert provided he exercises adequate skill and care. He cannot shift his liability on the ground that he had relied on the work of an expert. He continues to be responsible for forming and expressing his opinion on the financial statement.

2.6.3 Work of an expert and the auditor's report

On evaluation of the work of an expert, the auditor may opine that the work of the expert is inconsistent with the information in financial statements or the work does not constitute sufficient audit evidence as the expert refuses to disclose sources of the data used by him.

The auditor, in that case, should express qualified opinion or a disclaimer of opinion or adverse opinion as may be considered appropriate.

2.7 Reliance upon the work of another auditor

AAS-10, "Using the work of another auditor", prescribes the responsibility of the principal auditor in relation to his use of the work done by the other auditor.

When one auditor does not audit the whole of the entity then for auditing the different branches situated at different locations other auditors are appointed, called as Branch auditors and the auditor who reports to the owners of the entity is called principal auditor. In such situations the branch or divisional auditor reports to the principal auditor and the principal auditor reports to the shareholders of the entity on total financial statements including these branches audited by others.

2.7.1 Audit procedure for using the work of other auditor

The principal auditor should follow the following procedure :

(i) The principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of ICAI.

(ii) Coordination with other auditor while planning the audit work.

(iii) Discussion with other auditor.

(iv) The principal auditor should consider the significant findings of the other auditor.

(v) Advise other auditor as regards significant accounting, auditing and reporting requirements.

(vi) The principal auditor through performing various audit procedures should obtain sufficient appropriate audit evidence that the work of other auditor is adequate for principal auditor's purpose in the context of the specific assignment.

2.7.2 Responsibility of Principal and other auditor

When the principal auditor makes his opinion about the financial information of an entity after relying upon the statements and reports of the other auditors, his report should clearly mention the division of responsibility for the financial statement. The report of the principal auditor must indicate the extent to which the financial statement audited by the other auditor have been included in the total financial statement of the entity. e.g., the number of branches audited by other auditor. The principal auditor can not be made responsible in respect of the work performed by the other auditors except in circumstances which should have aroused his suspicion about the reliability of the work done by the other auditors.

2.7.3 Reporting considerations

When the principal auditor based on his audit procedures concludes that the work of the other auditor cannot be used and he has not been able to perform sufficient audit procedure in respect of the financial information of the division audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of the audit.

2.8 Questions

1. What is an audit planning? What are its need?
2. State the steps in audit planning.
3. Is it necessary for an auditor to make notes in course of the conduct of an audit? Comment.
4. What do you mean by audit working papers?
5. What information would you expect to see on a permanent audit file of a limited company.
6. What are the contents of audit working papers ? Who can claim the ownership of these papers.
7. What is the general principle as envisaged in AAS-10, regarding the reliance to be placed by the principle auditor on the work of the other auditor?
8. State the provisions of respective AAS in respect of the following :
   (1) Reliance on the work of an internal auditor.
   (2) Reliance upon the work of an expert.
9. Discuss how far the external auditor can depend upon the work of the internal auditor ?

Unit 3 ❐ Evaluation of Internal Control System and Internal Audit

Structure

3.0 Objectives

After reading and studying this unit, the learner should able to

- Understand the nature and scope of Internal Control System.
- Know the need for evaluation of Internal Control System and the technique for such evaluation.
- Prepare the internal control questionnaire and flow-charts.
- Describe the concept of internal audit and its importance in the present day business environment.
- State the role of audit committee.

3.1 Introduction

This unit deals wih the definition, nature, scope and objectives of internal control system. In view of the importance of the system of internal control as the basis for determining the extent of the audit tests the auditors are always interested in the operations of accounting and internal control systems. In line with this, the evaluation of internal control system have been discussed in detail as to its need, stages and techniques. Concept of internal audit including its scope, need, objectives are elaborately stated. It also describes the Audit Committee and its role as per the requirements of SEBI and Companies Act.

3.2 Internal Control

Internal Control is one of the basic factors in the management of an organisation. It may be compared with the nervous system of a human body as it governs all operations and policies and keep them within practicable performance ranges. It is the primary responsibility of every management that they should establish and maintain sufficiently adequate system of internal contol commensurate with the size and nature of the business.

3.2.1 Definition of internal control

According to AAS-6, "Risk Assessments and Internal Control", Internal Control System means all the policies and procedures (Internal controls) adopted by the management of an entity to assist in achieving managements objective of ensuring, as far as practicable,-

- the orderly and efficient conduct of its business including adherence to management policies

- the safeguarding of assets
- the prevention and detection of fraud and error
- the accuracy and completeness of the accounting records, and
- the timely preparation of financial information.

Internal control is a process effected by an entity's board of directors, management, and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories :-

(a) Reliability of financial reporting.

(b) Compliance with applicable laws and regulations.

(c) Effectiveness and efficiency of operations.

3.3.2 Objectives

The management of an entity determines the objectives of internal control system taking into consideration the nature of the business, scale of operations, degree of profesionalisation of the management, etc. AAS-6 specefies the following objectives of internal controls relating to the acounting system.

1. Transactions are executed with management's general or specific authorisation.
2. Assets and records are safeguarded from unauthorised access, use or disposition.
3. All transactions and other events are promptly recorded in an appropriate manner that may facilitate preparation of financial statement as per applicable laws, policies, standards and help in maintaining accountability for assets.
4. Assets are physically verified at reasonable intervals and appropriate action is taken with regard to any differences.

3.2.3 Scope of internal control

According to the council of the Institute of Chartered Accountants of England and Wales, "Internal Control means the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records."

Thus, the scope of internal control extends beyond accounting controls and includes all operational controls such as -

- Quality Controls
- Work Standards
- Projectory Controls
- Periodic Reporting
- Policy appraisal
- Quantitative Controls etc.

AAS-6 recognises that internal control system extends beyond these matters which relate directly to the functions of accounting and finance departments and includes control envorinment and control procedures. Control environment basically reflects management phylosophy and attitude. Control procedure are the policies and procedure established by the management to achieve the entity's specific objectives.

The term internal control may be classified into two broad categories, i.e. accouniting controls and administration controls. Accounting controls implies the plan of organisation and the procedure and records that are concerned with the safeguarding of assets and the reliability of financial records. Such controls ensure that transaction have been executed with proper management's authorisation, the assets are properly maintained and financial records are in comformity with GAAP. Administrative controls comprise all other controls concerned with decision making process leading to management's authorisation of transactions. An auditor primarily reviews the accounting controls as it has direct and significant bearing on the reliability of financial statements and evaluates only those administrative controls which have a bearing on the reliability of the financial records.

3.2.4 Need for evaluation of internal control

The evaluation of internal control is fundamental to an audit. AAS-1, 'Basic Principles governing an Audit', states that the auditor should have an understanding of the accounting system and related internal controls. It also requires that the auditor should study and evaluate the operation of these internal controls. It is on the basis of this evaluation the auditor

a) Determines the nature and extent of his audit procedures.

b) Drafts his letter of weakness, drawing the attention of management to weakness in the system.

The enormous growth in size and complexity of modern business organisations also require an effective system of internal control as it is not possible by the auditor to verify the large number of transactions of an organisation due to time and resource constraints. Remarkable development in the field of information technology and its increasing use in maintaining of accounts has enhanced the need for evaluation of internal control system in an organisation. EDP system of accounting has changed the flow of documents and transactions. The auditor may not have the intermediary documents and links required for audit and in such a situation he has to rely largely on the in-built control in the system.

3.2.5 Stages in evaluation of accounting and internal control systems

AAS-6 prescribes the stages involved in the evaluation of accounting and internal control systems. These stages help the auditor to assess control risk.

The stages are stated below:

1. Understanding the system:

The auditor should obtain an understanding of the accounting system sufficient to identify and understand:

a) Major classes of transactions in the entity's operations:

b) How such transactions are initiated

c) Significant accounting records. Supporting documents and specific accounts in the financial statement; and

d) the accounting and financial reporting process from the initiation of significant transactions and other events to their inclusion in the financial statements. At this stage the auditor should develop an integrated understanding of the accounting and internal control system sufficient to make an overall audit plan. The auditor should also obtain an understanding of the control environment sufficient to assess managements attitude, awareness and actions regarding internal controls and their importance in the entity. Understanding of the systems is obtained in the following ways:

- Previous experience with the entity
- Discussions with the personnel at different levels
- Going through the documents like organisation charts, procedure manuals, job descriptions, systems description and flow charts
- Inspection of documents and records
- Observations of the entity's activities and operations including computer operations and data procesing.

2. Assessment of control risk

After obtaining an understanding of the accounting system and internal control system, the auditor should make preliminary assessment of control risk for each material account balance or class of transactions.

The assessment of control risk is the process of evaluating the likely effectiveness of an entity's accounting and internal control systems in preventing or detecting and correcting material misstatements.

3. Tests of control

The auditor should obtain audit evidence through tests of control to support any assessment of control risk which is less than high. The lower the assessment of control risk, the more evidence the auditor should obtain that accounting and internal control systems are suitably desgined and operating effectively.

Control risk is the risk that internal control structure will fail to detect errors equal to the tolerable limit. For example suppose it is system of the organisation that whenever an employe goes on tour taking advance the same is debited to staff advance account in which other advances like car advance, festival advance is also debited. On submission of travelling expenses after completing the tour, staff advance account is adjusted and the amount is charged to travelling expenses account. In this system of internal control of travelling advance there is possibility that it will remain unadjusted and not debited as travelling expense if the employee does not submit or forget to submit the travelling bill. Thus there is a risk that travelling expenses of a particular period may be understated materally. It is a kind of control risk because internal control system may fail to detect the understatement of travelling expenses. Tests of control is the process of obtaining evidence that accounting and internal control system designed by the management is working effectively throughout the year. It may include

- Inspection of documents, supporting transactions and examining in depth with regard to procedural and control aspects.
- Inquiries about and observation of internal controls which have no audit trail.
- Re-performance of internal control (for example reconciliation of bank accounts)
- Testing of internal control operating on specific computerised applications (for example, access or program change controls)

4. Documentation

The auditor should document in the audit working papers:

a) the understanding he has obtained in the entity's accounting and internal control system and

b) the assessment of control risk.

If the assessment of control risk is less than high the auditor should also document the basis of such conclusion. The form, extent and design of documentation depends on the size, complexity of the entity as well as the nature of accounting and internal control system prevailing in the entity.

5. Communication of weaknesses

The auditor should communicate to the management, at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to his attention. The communication of weaknesses to the management would generally be in writing but if the auditor consists appropriate oral communication may be done but in that case such oral communication must be documented in the audit working papers.

3.2.6 Techniques for evaluation of internal control system

For evaluation of internal control system different techniques are used. Selection of a particular technique depends on the auditor's judgement. Two most common techniques of internal control evaluation are internal control quastionnaires and flow charts.

Flowcharts

Flowcharts are graphic descriptions of the information flow in a system. It helps to obtain a visual overview that may not be acuired from reading a narrative description of that same system. Thus, the auditor can often see control procedure in the system design more quickly and easily.

Flowcharts can be obtained from the client's personnel, if available, or the auditor can create them from observations, questions, and other available information.

Well-designed flowcharts should have the following **advantages:**

(1) The diagrammatic presentation of a complex system should be easier to comprehend than narrative ratio. This is of great value to members of the auditor's staff coming onto the audit for the first time;

(2) In order to depict the system in this form, the auditor is compelled to understand it fully.

(3) Each part of a complex system can be fully depicted by breaking the system down into a large number of seperate charts. These charts can be cross-referenced to each other to show the connection betwen different parts of the system.

(4) The depiction of the system in diagrammatic form should make the absence of controls or checks that the auditor would expect to find readily apperent.

(5) It helps the auditor to analyse the system to find out how effectively it works and to detect easily the weaknesses in the system.

(6) It enable an auditor to record information regarding systems accuracy and comprehensively.

The following **problems or limitations** relating to flowcharting should be recognised:

(1) If flowcharts are used in relation to small enterprise with simple acounting systems, they may well involve cost and effort out of proportion to the benefit.

(2) Audit staff must be properly trained to prepare and interpret them, and standard charting techniques must be in use throughout a term; and

(3) They do not indicate all the internal controls in operation, particularly those relating to the custody of assets. This is not a disadvantage provided they are used in combination with an internal control questionnaire or equivalent checklist to which they are referred.

Internal Control Questionnaires (ICQ)/checklists:

An internal control questionnaire (ICQ) is basically a comprehensive list of questions that an auditor may ask in order to assess the existance and efficiency of an internal control system. It is considered to be the most convenient method of collecting information regarding the internal control system and since it is pre-designed, it can ensure coverage of all aspects of control. To facilitate the assessment the questions are asked in a form that the answer can be given by merely ticking the appropriate word (yes/no/not applicable). There must be sufficient space below each question so that answer can be amplified where necessary. The list of questions must be logical and should follow a sequential pattern. Whichever method is followed, care must be taken to ensure that answers given truly represent the system as it actually exists. This should be done by means of observation, and by listing a limited number of items through the system, known as "work-through checks". It can be kept in audit working papers as a record of the auditor's evaluation of the internal control system.

An illustrative questionnaire regarding wages and salaries is given below although it is not possible to establish a comprehensive standards of internal control as it varies in different business situations.

Internal control questionnaire
Wages and salaries

1. Who has authority?
   (a) to engage
   (b) to dismiss employees?
2. Are history cards maintained of all employees, containing the employee's signature?
3. Who authorises (a) overtime and (b) general and individual increase in pay?
4. Is such authority always evidence in writing?
5. Is the person with such authority seperate from the salaried personnel?
6. What records are maintained in respect of:
   (a) time work
   (b) piece-work?
7. How are piece-work quantities checked and how is partly finished work dealt-with at the end of each week?
8. If job cards or piecework cards are produced, who authenticates these?
9. Are these authenticating records on the shop floor independent of the wages department?
10. Who prepare the payroll?
11. Is the work so allocated that no one aspect of the compilation of the payroll is carried out completely by one member of staff?
12. Is the payroll checked periodically with the history records as to names and details of payment?
13. Is this carried out by a person independent of those preparing the payroll?
14. Are all calculations and additions checked independently?
15. Is the payroll authorised by a responsible official when completed and before the cheque is drawn?
16. How are wages packets prepared? Is the cash counted twice by independent persons before putting it in the envelopes? Are there automatic reconciliations of cash drawn and cash put in wage packets?

1. Are wages disbursed on fixed days and timings?

18. Are those who distribute wages independent of those who prepare the payroll?

19. Is authority in writing required before a representative of an employee is paid?

20. Are proper identifications and receipts procured before disbursement of wages.

21. What arrangements are in force to deal with any disagreement as to the amount paid out?

22. When are unclaimed wages recorded?

23. Who retains unclaimed wages?

24. How long are they retained before being paid into the bank?

25. Who authorises the payment of unclaimed wages?

26. Is there proper identification of person claiming unclaimed wages? Are these paid through a seperate voucher?

27. Are the deductions on account of employee's state insurance and provident fund deposited within the stipulated period?

28. Are the amounts determined on account of income tax and under compulsory deposit schems, deposited in the relevant accounts?

29. Are payroll records subjected to internal audit periodically ? Do the reports of the internal auditor show any material errors or weaknesses in the system?

3.3 Internal Audit

Internal audit is an audit involving an examination and evaluation of various activities of an enterprise conducted on behalf of the management with the objective of assisting the management to discharge its responsibilities effectively.

Internal audit involves conducting a systematic examination of the record, systems, procedures and operations of an organisation as a service of the management.

Internal audit is conducted on behalf of the management to ensure that :

(a) The exising internal controls are effective and adequate

(b) The financial and other records and reports show the results of the operations accurately and promptly.

(c) Each division / unit of the organisation follows the policies and procedures laid down by the top management.

(d) The assets of the organisation were adequately sefeguarded and properly accounted for.

Modern concept :

The Institute of Internal Auditors (IIA), USA has defined internal auditing ''as an independent and objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectivenes of management control and governance process''. Internal audit can be done by persons within or outside the organisation. Internal auditor is appointed by the management and is a part of overall organisation system of internal control.

3.3.1 Scope and Objectives

As per AAS-7 "Relying upon the work of Internal auditor", the scope and objective of internal audit vary depending upon the size and structure of the organisation and the requirements of the management.

Generally it operates in one or more of the following areas :

(a) Review of accounting system and related internal controls.

It is the responsibility of the management to establish an adquate accounting system and related internal controls. The internal audit function is assigned the specific responsibility for reviewing the accounting system and related internal control system and their operation and recommending suggestions for thier improvements.

(b) Examination for management of financial and operating information

It includes review of the methods used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.

(c) Examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organisation.

(d) Physical examination and verification

It includes examination and verification of physical existence and condition of the tangible assets of the entity.

As per the recommendations of Institue of Internal Auditors (IIA), USA the emphasis of modern internal auditing should be on (i) Risk management and control, and (ii) Governance.

Risk Management and Control :

The internal audit function should contribute towards improvementof risk management and control through evaluation of the following :

* Reliability and Integrity of Financial and Operational Information.
* Compliance with laws, Regulations and Contracts
* Safeguarding of assets.
* Effectiveness and efficiency of operations.
* Accomplisment of objectives and goals for operations or Programms.

Governance :

The internal audit, for the improvement of governance process, should evaluate and make appropriate recommendations. It helps to achieve the following :

* Promotion of ethics and values within the organisation.
* Effective organisational performance management and accountability

* Effective communication of risk and control information to appropriate areas of the organisation.
* Effective coordination of the activities and communication of information among the board, external and internal auditors, and management.

3.3.2 Internal Control and Internal Audit

As per AAS-6 the internal control system is defined as all the policies and procedures adopted by the management of an entity to assist in achieving management's objectives of ensuring, as far as practicable, the orderly and efficient conduct of its business including adhererence to management policies, the safeguarding of assets, the presentation and deletion of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

As mentioned earlier, the internal audit is defined as an independent and objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplis its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process.

Internal control is the whole system of controls while internal audit is one of its important constituents. Internal audit is essentially a post-transaction review to evaluate the records, controls and operations in an organisation. For example, in case of the purchase department, internal control system would include allocation of managerial authorities, procedures of carrying out the various functions, post-transaction audit, performance appraisal and periodic reporting. This post-transaction audit must be internal audit involving a review of what actually happened, e.g. whether purchase order have been placed in the best competitive manner and whether there was a proper follow up of orders. Thus internal audit is a part of overall system of internal control.

3.3.3 Internal control, Internal Audit and Companies Act

According to section 227 (4A) of the Companies Act, Companies (Auditor's Report) Order, 2003 an auditor requires to report, on internal control and internal audit.

According to section 227 (4A) of the Companies Act, the Companies (Auditor's Report) order 2003, requires an auditor to include a statement in his audit report containing the following in respect of internal control and internal audit matters.

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

2. Whether the company has an internal audit system commensurate with its size and nature of its business in the case of listed companies and / or other companies having

a paid-up capital and reserves exceeding Rs. 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned.

This provision is, however, not applicable to (i) a private limited company with a paid up capital and reserves not more than fifty lakh rupees and has not accepted any public deposit and does not have loan outstanding ten lakh rupees or more from any bank or financial institution and does not have a turnover exceeding five crore rupees.

(ii) a company listed to operate under section 25 of the Act and

(iii) a banking company.

(iv) an insurance company.

3.4 Audit Committee

An audit committee is a committee of the board of the directors of a company entrusted with the responsibility of overseeing the company's financial reporting process, reviewing the financial and risk management policies of the company, considering various issues relating to audit function like recommendations on appointment and remunaration of auditor, review of audit findings etc.

3.4.1 Requirements under the Companies Act

In India, the section 292A of Companies Act, 1956 (inserted by Companies (Ammendment) Act, 2000) provides for the constitution of Audit Committee. It requires the following in respect of composition, powers, functions etc, of the audit committee.

1. Every public company having paid-up capital of not less than five crores of rupees shall constitute a committee of the Board known as "Audit Committee". The Committee should consist of not less than three directors of which two-thirds of the total number of members shall be directors, other than managing or whole time directors.
2. The committee should act in accordance with terms of reference as specified in writing by the Broad.
3. The members of the Committee should elect a chairman from amongst themselves.
4. The annual report of the company must disclose the composition of the audit committee
5. The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at the meetings of the audit committee but shall not have the right to vote.
6. The audit committee should have discussions with the auditors periodically about the internal control systems, the scope of audit including the observations of the

auditors and review of the half-yearly and annual financial statements before submission to the board and also ensure compliance of internal control systesm.

7. The audit committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice if necessary.
8. The recommendation of the audit committee on any matter relating to the financial management including the audit report, shall be binding on the Board.
9. If the Board does not accept the recommendation of the audit committee, it shall record the reasons therefor and communicate such reasons to the shareholders.
10. The chairman of the audit committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.
11. If a default is made in complying the provisions of this section, the company, and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, a with fine which may extend to fifty thousand rupees, or with both.

3.4.2 Requirements of Listing Agreement

Every listed private and public sector company, to which clause 49 of the listing agreement applies, shall have to comply with the provisions of clause 49, in adiition to provisions of sectron 292A, which are as follows :-

Composition

A qualified, independent audit committee should be set up by the company with the following compliances :

(i) The audit committee shall have minimum three members, all being non-executive directors, with the majority of them being independent, and with atleast one director having financial and accounting knowledge.

(ii) The chairman of the committee shall be an indepedent director.

(iii) The chairman shall be present at annual general meeting to answer shareholders queries;

(iv) The audit committee invites such of the executives, as it considers appropriate (and paricularly the head of the finance function) to be present at the meeting of the committee, but on occasions it may also meet without the presence of any exceutives of the company.

(v) The company secretary shall act as the secretary to the commiteee.

Meetings

The audit committee shall meet atleast four times a year and not more than four months shall elapse between tow meetings. The quorum shall be either two members or one third of the members of the audit committee, whichever is higher and minimum of two independent directors.

Powers

The audit committee should have sufficient powers which should include the following :

1. To investigate any activity within its terms of references.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

3.4.3 Role of Audit Committee

The role of audit commitee should include the following :

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.

2. Recommending the appointment and removal of external auditor, fixation of audit fee and also approval of payment for any other services.

3. Reviewing with management the annual financial statements before submission to the board, focusing primarily on.

(a) Any changes in accounting policies and practices and reas an for the same
(b) Major accounting entries based on exercise of judjement by management.
(c) Qualifications in draft audit report
(d) Significant adjustments arising out of audit
(e) The matters required to be included in the Directors Responsibility Statement.
(f) Compliance with accounting standard
(g) Compliance with stock exchange and legal requirements concerning financial statements
(h) Any related party transaction of the company of material nature, with promoters of the management, thier subsidiaries or relatives etc. that may haver potential conflict with the interest of company at large.

4. Revewing with the management, performance of external and internal auditors, the adequacy of internal control system.

5. Revewing the adequacy of internal audit function, including the structure of internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.

6. Discussions with internal auditors on any significant findings and follow-up thereon.

7. Reviewing the findings of any internal investigation by the internal auditors into matters where there is suspected fraud or irregularity on a failure of internal control system of a material nature and reporting the matter to the Board.

8. Discussions with external auditors before the commencement of audit about nature and scope of the audit as well as post audit discussion to ascertain any area of concern.

9. Reviewing the company's financial and risk management practices.

10. Looking into the reasons for substantial default in the payment to depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.

11. Reviewing with the management the quarterly financial statements before sub mission to the board for approval.

3.5 Questions

1 Define an internal control system.
2. State the objective of internal control system.
3. Explain the scope of internal control system.
4. What is the need for evaluation of internal control.
5. Describe the stages in evaluation of internal control system.
6. What is a flowchart? What are its advantages?
7. What is an internal control questionnaire (ICQ) or checklists? Prepare an ICQ or checklist for wages and salaries in respect of huge manufacturing organisation?
8. Define Internal audit, what are its scope and objectives?
9. "Internal audit is a part of overall system of internal control"–explain.
10. What is an audit committee? Discuss the requirements of the Companies Act and SEBI with respect to such committee.
11. Is internal audit compulsory for every company?
12. State the role of audit committee?

Unit 4 ❒ Statements / Standards and Guidance Notes

Structure

4.0 Objectives

After Studying this unit, you should be able to :

- Understand the importance of 'accounting standard' and 'auditing and assurance standards.'
- Explain the ideas of generally accepted accounting principles (GAAP)
- State the details of accounting standards and auditing and assurance standards issued by ICAI
- Learn the compliance aspects of accounting standards, AAS and standards issued under the Income tax Act.

4.1 Introduction

It is the primary concern for every auditor to determine whether generally accepted accounting Principles (GAAP) in India have been properly applied in preparation and presentation of financial statements. Therefore a thorough knowledge of GAAP and its compliance requirements is essential for the auditor. Accounting standards, the guidance notes on accounting matters issued by ICAI and Income-tax Standard, all are considered to be the most important elements of Indian GAAP. The auditor should also keep in mind the auditing and assurance standards (AASs) issued by ICAI to ensure quality and effective audit performance. So, this unit deals with the concept of Indian GAAP and presents a summarised view of ASs and AASs issued by ICAI, standards as issued by income tax authorties and their compliance requirements.

4.2 Generally Accepted Accounting Principles (GAAP)

Generally Accepted Accounting Principles (GAAP) comprises of accounting conventions, rules, procedures, statutory requirements of various acts, accounting standards, accepted accounting practices both promulgamated and non-promulgamated. GAAP are those principles which have substantial authorative support.

GAAP denoted a set of accounting rules or directive guidelines or code of action which are accepted in general by the accourding bodies of different countries.

In Indian context GAAP includes the following :

- Accounting conventions, rules, procedures
- Accounting standards issued by ICAI
- Statements, guidance notes issued by ICAI
- Requirements of Companies Act,
- Requirements of Income tax Act, & other relevant acts like FEMA etc.

- Requirements of SEBI
- Standards issued by ICWAI, Income Tax Authorities etc.
- Other acceptable accounting practices etc.

4.2.1 Global Accounting Harmonisation

Harmonisation in the accounting context may be defined as the process aimed at enhancing the comparability of financial statement produced by different organisation situated in different countries on the basis of their respective accounting regulation. Globalisation of business, capital markets highly demands the harmonised set of accounting rules and regulation in respect of preparation and disclosure of financial information.

In Indian context the main organisations involved in global accounting harmonization are :—

- International Accounting Standard Board (IASB).

–Which issues International Accounting Standards (IAS)

- Combination of statements/ opinion/ interpretation issued by the following main organisations of IAS are termed as IAS GAAP.

– Financial Accounting Standard Board (FASB)
– American Institute of Certified Accountants (AICA)
– Emerging issues Task Force (ETF)
– Securities and Exchange Commission (SEC)

- The Institute of Chartered Accountants of India

Statements, standards, guidance notes issued by the ICAI.

4.2.2 Importance of GAAP

GAAPs stand for the broad framework of accounting rules within the boundary of which the accountants enjoy independence of deciding upon their courses of action to solve definite accounting problems. GAAPs have gained tremendous importance in present day accounting. If there is no GAAP the accountants of different countries would follow their own principles of accounting resulting in disorder and indiscipline. So GAAP, are regulatory codes which bring unformity in accounting practices, GAAPs aim to provide material, verifiable and less complex financial information to the users of financial statements, GAAPs are expected to achieve the following objectives :

(a) Providing a significant and reliable meaning to the financial statements prepared in the accounting process.

(b) Providing guidelines for making verifiable measurement of accounting income and valuation of assets and liabilities.

(c) Fixing up acceptable standards helpful for bringing uniformity in accounting action and making possible easier inter-firm comparison by ignoring time and distance barriers.

4.2.3 Significance of GAAP in Audit

Sub-sections (1) and (2) of section 211 of the Companies Act, 1956 state the fundamental characteristics of the financial Statements. As per this section every Balance Sheet would give a true and fair view of the Statement of affairs of the company at the end of the financial year and every Profit and Loss Account should give a true and fair view of the profit and loss of the company for the financial year. This qualitative characteristics of true and fairness can be ensured if such financial statement have been prepared and prescribed in compliance with generally accepted accounting principles.

Section 227 of the Companies Act requires that an audit on examination of financial statements should make an opinion about the true and fairness of the financial information contained in balance sheet and profit and loss account. Also an auditor is required under this section to opine that whether profit and loss account and balance sheet comply with the accounting standard as referred in sub-section (3C) of section 211.

Therefore the auditor is primarily concerned with the verification of compliance aspect of GAAP in preparation and presentation of financial statements made by the companies.

4.3 Professional Pronouncements in India : Publications of ICAI

From time to time, ICAI issues various documents on specific matters of importance to accountants and auditors. These documents may be classified into six categories as follows :

1. Accounting Standards (ASs) and Accounting Standards Interpretations (ASIs).
2. Auditing and Assurance Standards (AASs).
3. Other Statements on accounting and auditing.
4. Guidance Notes on matters relating to accounting, auditing, taxation, company law, ethics and other related matters.
5. Opinions on specific quaries.
6. Research Studies, monographs and other miscellaneous publications.

4.4 Accounting Standards

4.4.1 What is AS ?

Accounting Standards are the policy documents issued by recognised expert accountancy body, by government or other regulatory body relating to various aspects of recognisation, measurement, treatment, presentation and disclosure of accounting transaction in the financial statements. Accounting standards in India are issued by the Institute of Chartered Accountants of India (ICAI).

4.4.2 Objective of Accounting Standards

The purpose of accounting standards is to standarise diverse accounting policies with a view to eliminate to the extent possible, incomparability of financial statements, information and provide a set of standard accounting policies, valuation norms and disclosure requirements, to discourage pursuance of accounting policies which are not in conformity with the generally accepted accounting policies. It adds the reliability to the financial statements.

4.4.3 Indian Accounting Standards

In India the Institute of Chartered Accountants of India, recognizing the need to harmonize the diverse accounting policies and practices, constituted an Accounting Standard Board (ASB) on 21 April, 1977 with the function of formulating accounting standards. ICAI has been issuing Accounting Standards on significant accounting issues. These standards are formulated in the light of the International Accounting Standards and the conditions and practices prevailing in the country.

Following are the accounting standards as has been issued by the ICAI.

AS 1	Disclosure of Accounting Policies
AS 2	Valuation of Inventories
AS 3	Cash Flow Statements
AS 4	Contingencies and Events Occuring after the Balance Sheet date
AS 5	Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies.
AS 6	Depreciation Accounting
AS 7	Construction Contracts
AS 8	Accounting for Research and Development (This AS stands withdrawn from the date AS 26 becomes mandatory)
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11	The effect of changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 15	Accounting for Retirement Benefits in the Financial Statements of Employers.
AS 16	Borrowing costs
AS 17	Segment Reporting

AS 18	Related Party Disclosures
AS 19	Leases
AS 20	Earnings Per Share
AS 21	Consolidated Financial Statements.
AS 22	Accounting for Taxes on Income.
AS 23	Accounting for Investments in Associates in Consolidated Financial Statements.
AS 24	Discontinuing Operations
AS 25	Interim Financial Reporting
AS 26	Intangible Assets
AS 27	Financial Reporting of Interest in Joint Ventures
AS 28	Impairement of Assets
AS 29	Provisions, Contigent Liabilities and Contigent Assets

4.5 Auditing and Assurance Standards

4.5.1 Introduction

Auditing involves collection and evaluation of evidence to determine and report as to whether the financial information have complied with all established criteria and whether it exibits true and fair view. To ensure consistent, objective, reliable and quality audit services a large number of Standards have been developed over period of time which are known as generally Accepted Auditing Standards. In USA generally Accepted Auditing Standards were first issued in 1939 with 10 Standards, called as ‘‘Rule of the Road’’, governing the quality of professional work.

4.5.2 What is AAS?

AAS are the benchmarks by which the quality of audit performance can be measured and the achievement of objective can be documented, with AAS an auditor can determine the professional qualities necessary for effective audit performance. AAS prescribes the way the auditing should be conducted.

4.5.3 Auditing and Assurance Standards issued by ICAI

In India Auditing and Assurance Standards Board was constituted in 1982 with the function of formulating Auditing and Assurance Standards (AASs). ICAI has been issuing a series of AASs in the line of corresponding International Standards on auditing as well as the applicable laws, customs, usages and business environment in India, ICAI has so far issued the following AASs :

AAS 1	Basic Principles Governing an Audit.
AAS 2	Objective and scope of the audit of Financial Statements.
AAS 3	Documentation
AAS 4	The Auditor's Responsibility to consider fraud and error in an audit of financial Statements.
AAS 5	Audit Evidence.
AAS 6	Risk Assessments and Internal Control.
AAS 7	Relying upon the work of an Internal Auditor
AAS 8	Audit Planning.
AAS 9	Using the work of an Expert.
AAS 10	Using the work of another auditor.
AAS 11	Representations by Management.
AAS 12	Responsibility of Joint Auditors.
AAS 13	Audit Materiality
AAS 14	Analytical Procedures
AAS 15	Audit Sampling
AAS 16	Going Concern
AAS 17	Quality Control for Audit Work.
AAS 18	Audit of Accounting Estimates
AAS 19	Subsequent Events
AAS 20	Knowledge of the Business.
AAS 21	Consideration of Laws and Regulations in an audit of Financial Statements.
AAS 22	Initial Engagements—Opening Balances
AAS 23	Related Parties
AAS 24	Audit considerations relating to entities using Service Organisations.
AAS 25	Comperatives
AAS 26	Terms of Audit Engagement.
AAS 27	Communications of audit matters with those changed with governance
AAS 28	The Auditors Report on Financial Statements
AAS 29	Auditing in a computer Information System Environment.
AAS 30	External Confirmations
AAS 31	Engagements to compile Financial Information
AAS 32	Engagements to Perform Agreed-upon Procedures regarding Financial Information.

4.6 Income Tax Standards

Under Section 145 of the Income-tax Act, (IT) 1961 the Central Government has been empowered to notify 'Accounting Standards'. These are to be followed by any class of assessees or in respect of any class of income. The central government has notified the following two Accounting Standards :

- AS (IT) I– Disclosure of Accounting Policies
- AS (IT) II– Disclosure of prior period items, extraordinary items and changes in accounting policies.

The Accounting Standards of ICAI is applicable to all enterprises whereas the Standards issued by central government as per section 145 of the IT Act is applicable only to those assessees who follow the mercantile system of accounting.

4.7 Compliance Requirements of Accounting Standards and Income-Tax Standards

(1) In respect of mandatory accounting standard, the duty of the members of the Institute, while discharging their function, will be to examine whether Accounting Standard is complied with in the persentation of financial statements covered by their audit. In the event of any deviation from the Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviation.

(2) Section 211 (3A) of the Companies Act 1956 requires that every profit and loss account and balance sheet of the company shall comply with the accounting standards.

Section 211 (3C) defines 'accounting standards' as standards of accounting which is recommended by ICAI and prescribed by the central government in consultation with the National Advisory Committee on Accounting Standards constituted by the Central Government under section 210A of the Act. The accounting standards specified as mandatory by ICAI would have to be complied with until as per the National Advisory Committee.Thus it is the responsibility of the company to comply with the requirements of the accounting standards.

(3) Section 211(3B) provides that in case of non-compliance the company should disclose the following in the financial statements :

(a) The deviation from the accounting standard

(b) The reason for such deviation.

(c) The financial effect, if any, arising from such deviation.

(4) As per section 227(3)(d) of the Companies Act, 1956 the auditor must also state in his audit report whether in his opinion the Profit and Loss Account and Balance Sheet comply with the accounting standards as referred in section 211(3C) of the Act.

(5) The Securities and Exchange Board of India also requires the compliance of accounting standards issued by ICAI to be one of the stipulations of the listing agreement between the stock exchanges and such companies.

(6) The auditor should also examine compliance with the accounting standard issued by ICAI while conducting the audit of financial statements under section 44AB of the Income Tax Act.

(7) As per the view of the Central Broad of Direct Taxes that standards under section 145 of IT Act will be issued in conultation of ICAI. If there is any diference in opinion between the standards then financial statements will be prepared as per accounting standards issued by ICAI. But in such a case adjustments are required to be made considering the requirements of Income tax Standard in the statement of computation of income for tax purposes.

(8) A tax auditor, as per clause 11(d) of form No 3CD, is required to report of the details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect there of the on profit or loss.

(9) Compliance with mandatory accounting standards is examined by auditors in auditing general perpose financial statements when such audit is conducted under any law irrespective of structure of the organisation.

(10) Form No. 3CD (Statement of particulars annexed to tax audit report) requires reporting of details of deviation from accounting standard (IT standards) prescribed under section 145 and effection thereof on the profit or loss.

Section 217 (2AA) of the Companies Act, 1956 requires that Directors' Responsibility Statement must specify that accounting standards had been followed in the preparation of annual accounts and / or explanation for material departure from accounting standards.

4.8 Compliance requirements of Auditing and Assurance Standards

Compliance with auditing standard is necessary in normal circumstances. Auditing Standards are expresed to be observed by the auditor when he seeks to express an opinion on the financial Statements.

It is the duty of the auditor being a member of ICAI to ensure that the audit is conducted in accordance with these AASs and material departure there from whenever necessary. In this context, clause 9 of part I of the Schedule to the Chartered Accountancy Act, 1949 is important which provides that a practicing Chartered Accountant shall be guilty of professional misconduct if he fails to invite attention to any material departure from the generally accepted audit procedure i.e. AASs applicable to the circumstances.

Auditor in his report has to mention that he has conducted the audit in accordance with 'generally accepted auditing standards'. The generally accepted auditing standards in Indian context means the AASs as issued by ICAI.

4.9 Questions

1. What do mean by GAAP? What is Indian GAAP?
2. What is the importance of GAAP?
3. What is Accounting Standard? State its objectives.
4. What is AAS (Auditing and Assurance Standard)?
5. State the compliance requirements of AS and Income-Tax Standard.
6. State the relevance of GAAP in relation to audit.
7. State the compliance requirements of AAS.
8. Write short notes on :
   (1) Harmonisation of global accounting.
   (2) Income-Tax Standards.

Unit 5 ❒ Audit of Limited Companies

Structure

5.0 Objectives

After Studying this unit, you should be able to :

- Know the statutory requirements which are essential for the audit of limited companies.
- Understand the idea of audit report and its contents.
- Define the phrase 'True & Fair' and explain its relevance in the context of audit report.
- Explain the concept of dividend and divisible profits and the statutory requirements with respect to that.
- Interpret the concept of independance of auditor.

5.1 Introduction

A proper understanding of all the relevant provisions of the Companies Act, 1956 alongwith schedule VI and schedule XIV to the act affecting audit and accounts is essential to assess whether or not the balance sheet and profit and loss account disclose all the necessary information in the prescribed manner. Financial statements are prepared and presented to exibit a true and fair view of the statement of affairs as well as profitability of the organisation. So emphasis has been given to explain the concept of true and fair view in the context of financial statements. The form of auditor's report and its contents including specific matter, to be dealt with in the report are given in detail. Independence of auditor being one of the basic principles in audit is discussed as to its concept and present day importance. So, in this unit, all the important featurs of company audit are discussed.

5.2 Qualification of auditor

Section 226 of the Act provides that only a Chartered Accountant as defined in Chartered Accountants Act, 1949 can act as an auditor of a limited company. (Section 226 (1)). It is further provided that a firm where of all the partners are practising chartered accountants can be appointed by its firm name as auditor in which case any partner may act in the name of the firm. Apart from practising chartered accountants, a holder of a certificate in an erstwhile Part B State which entitled him to act as an auditor of companies in the teritories of that State immediatley before November 1, 1956, is also entitled to be appointed as an auditor of companies registered anywhere in India. [Section 226 (2)].

As per Chartered Accountants Act, 1949 only a Chartered Accountant holding a certificate of practice can engage himself in the public practice of chartered accountancy.

So, under section 226 (1) and 226 (2) the following shall be qualified for appointment as auditor of a company.

1. A Chartered Accountant in practice.
2. A firm of practising chartered accountants.
3. A holder of certificate granted by any ertswhile Part B State. (more or less redundant)

However, such person, should not suffer from any of the disqualifications mentioned in Sub-sections (3) and (4) of section 226 of the Act and also should not hold audits within the limits specified in section 224 (1B) of the Act and those of notification, if any, issued by ICAI.

5.3 Disqualification of Auditor

Under section 226 (3), none of the following persons shall be qualified for appiontment as auditor of a company :

1. A body corporate.
2. An officer or employes of the company
3. A person who is a partner or who is in the employment, of an officer or an employee of the company.
4. A person who is indebted to the company for an amount exceeding rupees one thousand or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding rupees one thousand.
5. A person holding any security (i.e. instrument having voting rights) of the company.

Secton 226 (4) provides that a person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub-section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

Further section 226 (5) provide that if, after his appointment, an auditor becomes subject to any of the disqualifications listed above, he shall be deemed to have vacated his office as such.

5.4 Procedure of appointment of auditors

Section 224 of the Companies Act contains the provisions relating to the appointment of auditors of a company. The appointment of auditors of a company may be discussed in the following ways :

(a) Appointment of first auditor :

Section 224 (5) states that the first auditor or auditors of a company shall be appointed by the Board of Directors within one month of the date of registration of the company and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting.

However, a company may, at a general meeting, remove any such auditor or auditors and appoint in his or their places any other persons or persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting. This means first auditor can be removed at any general meeting prior to the first annual general meeting. Special notice is not required for that.

Section 224 (5) (b) provides that if the Board of Directors fails to appoint the first auditor, the company at a general metting may do so.

(b) Subsequent appointment of auditors

Section 224 (1) provides that every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed. As per Section 224 (1A), every auditor so appointed must, within 30 days of the receipt from the company of the intimation of his appointment, inform the Registrar in writing that he has accepted or refused to accept the appointment.

(c) Filling casual vacancy

Section 224 (6) provides that the Board of Directors may fill any casual vacancy (death, disqualification etc.) in the office of an auditor, but while any such vacancy continues, the remaining auditor or auditotrs, if any may act.

It is also provided that where casual vacancy is caused by the resignation of an auditor, the vacancy shall only be filled by the company in the general meeting.

Section 224 (6)(b) provides that an auditor appointed in a casual vacancy shall hold office until the conclusion of the next general meeting.

(d) Appointment by Central Government

Section 224 (3) provides that where at an annual general meeting no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. For that the company shall within seven days of the Central Government's power under sub-section (3) becoming exercisable, give notice of that fact to the government.

When an auditor is required to be appointed at an annual general meeting by a special resolution but the company omits or fails to pass such resolution due to any reason, it shall be deemed than no auditor has been appointed by the company at its general meeting and the provisions of section 224 (3) will be applicable. Again where auditors are not appointed or re-appointed at the annual general meeting in accordance with the provisions of the law (sections 188, 190 or section 225), the Central Government shall be eligible to appoint the auditor.

(e) Appointment of auditors by Special Resolution

Section 224A of the Act provides that in the case of a company in which not less then 25% of the subscribed share capital is held, whether singly or in any combination, by–

(a) a public financial institution or a government company or central government or any state government, or

(b) any financial or other institution established by any provincial or state Act in which a state government holds not less then 50% of the subscribed share capital, or

(c) a nationalised bank or an insurance company carrying on general insurance business.

the appointment or re-appointment at each general meeting of an auditor or auditors shall be made by a special resolution.

If at an annual general meeting the company omits or fails to pass a special resolution appointing an auditor or auditors, it shall be deemed that no auditor or auditors had been appointed there at. Therefore, the central government may appoint any person to fill the vacancy.

(F) **Appointment of auditors of Government Companies**

Section 619 of the Act provides that the auditor of government company shall be appointed or re-appointed by the Compotroller and Auditor-General of India (C & AG). According to 619B, the provisions of 619 of the Act shall also apply to a company in which the Central Government or any State Government or any Government Company or any Government Corporation held either singly or jointly not less than 51% of the paid up share capital. Thus, the auditors of such companies are to be appointed by C & AG.

5.5 Reappointment of retiring auditor

Section 224 (2) provided that subject to section (1B) regarding ceiling of audits and section 224A, regarding appointment of auditors by special resolution in certain cases, at any general meeting, a retiring auditor, by whatever authority appointed shall be re-appointed unless :

(a) he is not qualified for re-appointment; or

(b) he has given to the company notice in writing of his unwillingness to be re-appointed; or

(c) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be re-appointed; or

(d) where notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, but owing to that persons death, incapacity or disqualification the resolution cannot be proceeded with and so must be dropped.

5.6 Ceiling on number of audits

According to section 224 (1B), no company or its Board of Directors shall apoint or re-appoint any person (who is in full time employment elsewhere) or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as an auditor of the specified number of companies or more than the specified number of companies. (excluding private limited companies).

Specified number for this purpose means–

(a) in the case of a person or firm holding appointment as auditor of a number of companies each of which has a paid-up share captial of less than rupees 25 lakhs, twenty such companies.

(b) in any other case, twenty companies, out of which not more than ten shall be companies each of which has a paid-up share capital of Rs. 25 lakhs or more.

5.7 Remuneration of auditors

Section 224 (8) of the Companies Act provides that–

(1) In the case of first auditor or auditors appointed by it to fill a casual vacancy the Board of Directors can fix the remunaration.

(2) If the auditors is appointed by the central government that it may fix the remunation.

(3) If the auditor is appointed by the company at its general meeting or he is appointed under section 619 by C & AG, the remunaration shall be fixed by the company at the general meeting or in such manner as the company in general meeting may determine.

As per schedule VI of the Companies Act separate disclosure of all the amounts paid to an auditor is required to be made in the profit & loss A/c as follows :

(a) As auditor

(b) As advisor or in any other capacity in respect of–

(i) Taxation matters

(ii) Company law matters and

(iii) Management services

(c) Other amounts paid in any other manner.

It is important to mention here that in case of specified entities, the total fees for ‘other assignments’ from such an entity for a finanicial year cannot exceed its statutory audit fees and a statutory auditor can not do the internal audit of the same enterprise.

5.8 Removal of auditors

Section 224 (5) provides that the first auditor appointed by the Board of Directors may be removed at a general meeting by the company before the expiry of his term without the central governments prior approval. In this case, a special notice of at last 14 days is required for the appointments of any other person in his place.

Section 224 (7) states that any auditor, appointed (i) in an annual general meeting or (ii) by the Board to fill a vacancy, or (iii) appointed by the central government may be removed from office before the expiry of his term only by the company in general meeting, after obtaining previous approval of the central government in that behalf.

In all cases of removal of auditors before the expiry of their term, the provisions of section 225 shall apply.

At the expiry of his term, the company may in general meeting appoint another person in his place, but a special notice of any such resolution is necessary and also the provisions of sections 225 (2) and 225 (3) shall apply.

5.9 Powers or Rights of auditor

To enable the auditors to perform his task effectively the following rights have been given to them by the Companies Act.

1. He has right of access to all books, accounts and vouchers of the company at all times notwithstanding whether these are kept at its head office of elsewhere (Sec. 227).

2. Section 227 (1) of the act entitles the auditor of a company to require from the officers of the company such information and explanations as the auditor may think necessary for the performance of his audit as auditor.

Section 221 makes it obligatory for the officers of a company to furnish without delay the relevant information to the auditor.

3. Section 228 (2) provides that the auditor of a company has the right to visit branch offices and to have access to the books, accounts and vouchers maintained at the branch office both with some restrictions in the case of foreign branches of a banking company.

4. He has the right to attend any general meeting of the company and can make statements on any part of the business, which concerns him as auditor (Sec. 231).

5. He has the right to make comment upon the affairs of the company on the basis of the accounts audited by him.

6. He can authenticate the documents and returns of the company required to be certified by the auditor under the Companies Act 1956 (i.e. Statutory Report etc.)

7. He has a right to receive his remuneration (Sec. 224)

5.10 Duties of auditor

An auditor owes a number of duties to the company and to its members. The duties of an auditor are as follows :-

1. Duty to certify Profit and Loss Account in a prospectus (Section 56) :

A prospectus issued by an exiting company contains a statement showing profits and losses, assets and liabilities of a company and rate of dividends paid by it each year in the 5 financial years preceding the issue of the prospectus. This statements has to be certified by the auditor of the company.

2. Duty to certify the Statutory Report (Sec 165) :

An Auditor has to certify the corrections of the Statutory Report in resepct of the number of share alloted by the company, the total amount of cash received by the company by allotment of shares and abstruct of receipts and payments of the company.

3. Duty to make report (Sec 227)

The auditor shall make a report to the members of the company on the accounts examined by him.

The report should contain an opinion as to whether or not the balance sheet and profit and loss account exhibit a true and fair view of the state of affairs as well as profitibility of the organisation respectively. Apart from expressing this opinion certain other assertions are also required to be included in the company auditors report under the provisions of sub-section (2), (3), (1A) and (4A) of section 227 of the Act (discussed later under audit report).

4. Duty to assist the investigator (Section 240)

An auditor is required to produce before an inspector appointed under sectoin 235 of the Companies Act, 1956, all papers and books of the company which are in his custody and should also assist him in such investigation.

5. Duty of a Branch Auditor.

Under section 228, the branch auditor has to prepare a report on the accounts of the branch examined by him and forward the same to the company's auditor who is to deal with the same in such manner as he considers necessary.

Duty as per section 227 (4).

6. Section 227 (4) provides that if any of the matters in the auditors report is answered in negative or with a qualification the auditors report shall also state the reason for such an answer.

7. Duty to know his duties under Articles.

It is the duty of an auditor to make himself acquainted with his duties under the Articles of a company.

8. Duty to exercie resonable care and skill :

An auditor should excercise reasonable care and skill in discharging his duties.

9. An auditor is also required to certify cashflow statement and compliance of corporate governance requirements as per clause 32 and clause 49 of listing agreements respectively under SEBI Act.

10. An auditor also certifes the return of deposits to be filed with registrar by a company as per rule 10 of Companies (Acceptance of deposit) Rules, 1975.

5.11 Branch audit

Section 228 of the Companies Act provides that the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. If any branch office of the company is outside India, the accounts shall be audited by a person qualified to audit accounts according to the laws of that country or the company's auditor or a person qualified for appointment as auditor under the companyies Act, 1956. When a company decides at its general meeting that accounts of a branch office will be audited other than the company's auditor, in that case the appointment of the branch auditor may either be made by the company in that general meeting or the board of directors may be authorised to appoint the branch auditor in consultation with the company's auditor.

The terms and conditions of the appointment and the remunaration of such auditor is either fixed by the company in the general meeting or by the board of directors if so authorised by the company in general meeting.

The branch auditor shall have the same powers and duties in respect of the branch audit as the company's auditor. He shall submit his report to the company's auditor.

Sub-section (4) of section 228 empowers the Central Government to make rules regarding the exemption of any branch office from the aforesaid provisions to the extent specified in the rules.

5.12 Special Audit

Under section 233A of the Companies Act, 1956 the central government is empowered to order a special audit of the accounts of a company for a specified period in certain cirmustances.

The central government may at any time by order direct a special audit of the company's accounts if it is of opinion that :

(a) the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices, or

(b) the company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or

(c) that the financial position of any company is such as to endanger its solvency.

The central government may appoint either the company's auditor or any other chartered accountant as defined in section 2 (1)(b) of the Chartered Accountants Act, 1949 whether or not such Chartered Accountant is in practice.

The remunaration of special auditor should be determined by the central government and paid by the company.

The special auditor has the same powers and duties as a company auditor has under section 227 of the Companies Act with only one exception that he has to make the report to the central government instead of making his report to the members of the company containing all information as required under section 227 of the Companies Act and also information on any other matter as may be referred to the special auditor by the government.

5.13 Audit Report

5.13.1 Concept of Audit Report

The audit report is absolutely fundamental to the audit. The whole purpose of all the procedures carried out during the audit is to enable the auditors to express their opinion in their report to the members. It is the end product of every audit. Thus audit report declares the medium through which an auditor expresses his opinion on the financial statements or other data under audit.

5.13.2 Difference Between Report and Certificate

A report is a formal statement normally made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon.

A certificate, on the other hand, is a written confermation of the accuracy of the facts stated therein and does not involve any estimate or opinion.

5.13.3 Contents of Audit Report

A. **As per AAS-28 :**

An audit report generally states the scope of the audit and opinion of the auditor :

AAS 28, The Auditor's Report on Financial statements', establishes standards on the form and contents of the auditors report. According to the standard, the basic elements of the auditor's report are as follows :

1. Title

An appropriate title such as ''Auditor's Report'' helps to identify the report and to distinguish it from other reports.

2. Addressee

The report should be properly addressed as required by the terms of engagment and applicable laws and regulations. In the case of statutory audit of a company, the report is addressed to the shareholders.

3. Opening or Introductory Paragraph

This consists of–

(i) Identification of financial statements

The financial statements should be identified by including the name of the entity and the date of, and period covered by, the financial statements.

(ii) Responsibility

The opening paragraph should also state that the financial statements are the responsibility of the entity's management and the responsibility of the auditor is to express an opinion thereon.

4. Scope

The auditors report should describe of the scope of the audit of stating that the audit was conducted in accordance with auditing standards generally accepted in India (as per AAS) and that the audit was planned and performed to obtain reasonable assurance whether the financial statements are free of material misstatement.

The auditors report should describe the audit as including :

(a) examining, on a test basis, evidence to support the amounts and disclosures in financial statements :

(b) assessing the accounting principles used in the preparation of the financial statements;

(c) assessing the significant estimates made by management in the preparation of the financial statement; and

(d) evaluating the overall financial statement presentation.

The report should include a statement by the auditor that the audit provides a reasonable basis for his opinion.

5. Opinion Paragraph

The auditors report should clearly indicate the financial reporting framework (relevant statutory requirements like Companies Act for Companies, AS and other recongnised accounting principles and practices) used to prepare the financial statements and state the auditors opinion as to whether the financial statements give a true and fair view in accordance with that financial reporting framework and where appropriate, whether the financial statements comply with the statutory requirements.

In addition to an opinion on the true and fair view, the auditors report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant matters or law such as Companies Act in case of company.

6. Signature

The report should be signed by the auditor in his personal name. Where a firm is appointed as auditor, the report should be signed in the personal name of the auditor and in the name of the audit firm. The partner / proprietor signing the audit report should also mention the membership number assigned by ICAI.

7. Place of signature

The report should have a specific location, which is ordinarily the city where the audit report is signed.

8. Date of the report

The date of the auditors report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statement. Since the auditors responsibility is to report on the financial statement as prepared and presented by management the auditor should not date the report earlier than the date on which financial statements are signed or approved by management.

B. **As per Companies Act, 1956**

As per the relevant provisions of the Companies Act the contents of the audit report in respect of a company are the following :

1. Section 227 (2) provides that the auditor should make a report to the members of the company on the accounts examined by him, and on every balance sheet and profit and loss Account and other relevant documents and his report should state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by this Act in the manner so required and give a true and fair view–

(i) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and

(ii) in the case of the profit and loss account, of the profit or loss for its financial year.

2. The auditors report should also state–

(a) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books, and receipt of returns are adequate relating to the branches not visited by him.

(bb) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by clause (d) of sub-section (3) of that section and how he has dealt with the same in preparing the auditors report.

(c) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

(d) whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211;

(e) In thiek type or italies the observations or comments of the auditors which have any adverse effect on the functioning of the company;

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

(g) whether the cess payable under section 441A has been paid and if not, the details amount of cess not so paid.

(3) Section 227 (4) provides that whether any of the matters as referred to in clause (i) and (ii) of sub-section or in clauses (a), (b) (bb) (c) and (d) of sub-section 3 is answered in the negative or with or qualification, the auditors report should state the reason for the answer.

(4) Section 227 (1A) provides the auditor has to make an enquiry in respect of the following matters and he has to report only if he is not satisfied with the results of his enquiry.

Clause (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members.

Clause (b) whether transactions of the company which are represented merely by book entry are not prejudicial to the interests of the company;

Clause (c) whether the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consistent of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.

Clause (d)–whether loans and advences made by the company have been shown as deposits.

Clause (e)–whether personal expenses charged to revenue account

Clasue (f)–where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

(5) In accordance with the provisions of section 227 (4A) of the Companies Act the central government has issued a revised order in 2003, viz. The Companies (Auditor's Report) order 2003. (CARO '03). This order supercedes the earlier order known as MAOCARO '88.

The provisions of this order are in addition to the directions of the Comptroller and Auditor General under section 619 of the Act in respect of audit of government companies.

The specified matters that are required to be dealt with in the auditor's report under section 227 (4A) are given below :

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

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

(c) if a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern;

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

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

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

(iii) (a) has the company either granted or taken any loans, secured or unsecured to / from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions.

(b) whether the rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company;

(c) whether payment of the principal amount and interest are also regular;

(d) if overdue amount is more than one lakh, whether reasonable steps have been taken by the company for recovery / payment of the principal and interest;

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

(v) (a) whether transactions that need to be entered into a register in pursuance of section 301 of the Act have been so entered;

(b) whether each of these transactions have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time; (This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year).

(vi) in case the company has accepted desposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58A and 58AA of the Act and the rules framed thereunder, where applicable, have been complied with. If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board whether the same has been complied with or not?

(vii) In the case of listed companies and / or other companies having a paid-up capital and reserves exceeding Rs. 50 lakhs as at the commencement of the financial year concenred, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned; whether the company has an internal audit system commensurate with its size and nature of its business;

(viii) where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records have been made and maintained;

(ix) (a) is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth Tax, Custom Duty, Excise Duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

(b) in case dues of sales tax / income tax / custom tax / wealth tax / excise duty / cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may please be mentioned. (A mere representation to the Department shall not constitute the dispute.)

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

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

(xii) whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out.

(xiii) whether the provisions of any special statue applicable to chit fund have been duly complied with? In respect of nidhi / mutual benefit fund / societies;

(a) whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;

(b) whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard / doubtful / loss assets;

(c) whether the company has adequate procedures for appraisal of credit proposals/ requests, assessment of credit needs and repayment capacity of the borrowers;

(d) whether the repayment schedule of various loans granted by the nidhi is based on the repayment capacity of the borrower and would be conducive to recovery of the loan amount;

(xiv) if the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entires have been made therein; also whether the shares, securities, debentures and other securities have been held by the company, in its own name except ot the extent of the exemption, if any, granted under section 49 of the Act;

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

(xvi) whether term loans were applied for the purpose for which the loans were obtained;

(xvii) whether the funds raised on short-term basis have been used for long term investment and vice versa. If yes, the nature and amount is to be indicated;

(xviii) whether the company has made any preferenctial allotment of shares to parties and companies covered in the Register maintained under section 301 of the Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company;

(xix) whether securities have been created in respect of debentures issued?

(xx) whether the managment has disclosed on the end use of money raised by public issues and the same has been verified;

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

Where, in the auditor's report, the answer to any of the questions referred above is unfavourable or qualified the auditor's report shall also state the reasons for such unfavourable or qualified answer, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.

Audit report of two companies are given below for case study :

To the member of

Indian Aluminium Company Limited

1. We report that we have audited the attached Balance Sheet of Indian Aluminium Company Limited as at 31st March, 2002 and also the Profit and Loss Account for the year ended on that date annexed thereto both of which we have signed under reference to this report. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

2. We conducted our audit in accordance with auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as, evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
3. In our opinion and to the best of our information and according to the explanations given to us, the said accounts together with the notes thereon and attached thereto and the Statement on Significant Accounting Policies give in the prescribed manner the information required by the Companies Act, 1956, of India (the Act), and also give respectively, subject to the Note on Schedule 31 regarding remuneration of Managing Director, Operations awaiting Shareholders' approval to the extent indicate therein, a true and fair view in conformity with the accounting principles generally accepted in India :
   (a) in the case of the Balance Sheet, of the state of affairs of the Company as at 31st march, 2002 and
   (b) in the case of the Profit and Loss Account, of the profit for the year ended on that date.
4. We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit. In our opinion, proper books of account have been kept by the Company as required by law so far as appears from our examination of these books and the aforementioned Balance Sheet and Profit and Loss Account are in agreement therewith.
5. In our opinion, these accounts have been prepared in compliance with the applicable Accounting Standards reffered to in Section 211 (3C) of the Act.
6. On the basis of written representations received from the directors, as on 31st March, 2002 and taken on record by the Board of Directors, we reoprt that none of the directors is disqualified as on 31st March, 2002 from being appointed as a director in terms of clause (g) of sub-section (1) of Section 274 of the Act.
7. As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988 dated 7th September 1988 issued by the Government of India in terms of sub-section (4A) of Section 227 of the Act and on the basis of such checks as we considered appropriate and according to the information and explanations given to us, we further report that :

i. (a) The Companay has maintained proper records to show full particulars including quantitative details and situation of its fixed assets.
   (b) The fixed assets of the Company are physically verified by the management

according to a phased programme designed to cover all the items over a period of three years. Pursuant to the programme, a physical verification was carried out during the year and this revealed no material discrepancies.

ii. The fixed assets of the Company have not been revalued during the year.

iii. The stocks of finished goods, stores, spare parts and raw materials of the Company at all its locations have been physically verified by the management during the year.

iv. In our opinion, the procedures of physical verification of stocks followed by the management are reasonable and adequate in relation to the size of the Company and the nature of its business.

v. The discrepancies between the physical stocks and the book stocks which have been properly dealt with in the books of account were not material.

vi. In our opinion the valuation of stocks of finished goods, stores, spare parts and raw materials has been fair and proper in accordance with the normally accepted accounting principles in India and is on the same basis as in the preceding year.

vii. The Company has not taken any loans, secured or unsecured from companies, firms or other parties listed in the Register maintained under Section 301 of the Act.

viii. The Company has not granted any loans secured or unsecured to companies, firms or other parties listed in the Register maintained under Section 301 of the Act.

ix. The parties to whom loans or advances in the nature of loans have been given by the Company are repaying the principal amounts as stipulated and are also regular in payment of interest, where applicable.

x. In our opinion, there is an adequate internal control procedure commensurate with the size of the Company and the nature of its business, for purchase of stores, raw materials including components, plant and machinery, equipment and similar assets and for the sale of goods.

xi. The Company has not purchased goods and materials and sold goods, material and services aggregating Rs. 50,000/- or more in value from / to any of the parties listed in the Register maintained under Section 301 of the Act.

xii. The Company has a system of determining unserviceable or damaged stores, raw materials and finished goods on the basis of technical evaluation and on such basis, in our opinion, adequate amounts have been written off such stock in the accounts.

xiii. In the case of public deposits accepted by the Company, the directives issued by the Reserve Bank of India and the provisions of Section 58A of the Act and the rules framed thereunder have been complied with.

xiv. In our opinion, reasonable records have been maintained by the Company for the sale and disposal of realisable by-products and scrap, where applicable and significant.

xv. In our opinion, the Company's present internal audit system is commensurate with its size and the nature of business.

xvi. On the basis of the records produced, we are of the opinion that, prima facie, the cost records and accounts prescribed by the Government of India under Section 209(1) (d) of the Act have been maintained. However, we are not required to and have not carried out any detailed examination of such accounts and records.

xvii. The Company has regularly, deposited during the year, the Provident Fund and Employees' State Insurance dues with the appropriate authorities in India.

xviii. At the last day of the financial year there was no amount outstanding in respect of undisputed income tax, wealth tax, sales tax, customs duty and excise duty which were due for more than six months from the date they became payable.

xix. During the course of our examination of the books of account carried out in accordance with the generally accepted auditing practices in India, we have not come across any personal expenses which have been charged to Profit and Loss Account nor have we been informed of any such case by the management other than those payable under contractual obligations and accepted business practices.

xx. The Company is not a sick industrial company within the meaning of clause (o) of Section 3 (1) of the Sick Industrial Companies (Special Provisions) Act, 1985 of India.

xxi. In respect of services rendered, in our opinion, the Company has a reasonable system, commensurate with its size and the nature of its business, of (a) recording receipts, issues and consumption of materials and stores and allocating materials and stores consumed to the relative jobs, (b) allocating man-hours utilised to the relative jobs. In our opinion, there is a reasonable system of authorisation at properlevels with necessary controls on the issue of stores and allocation of stores and labour to various jobs and the related system of internal control of the Company is commensurate with the size of the Company and the nature of its business.

xxii. In respect of trading activities there are no goods in the possession of the Company as at 31st March, 2002.

P. Law
Partner
For and on behalf of
PRICE WATERHOUSE
Chartered Accountants

Mumbai,
2nd May, 2002
(Before introduction of CARO '03)

Auditors' report to the members of Infosys Technologies Limited

We have audited the attached Balance Sheet of Infosys Technologies Limited (the Company) as at March 31, 2005, the Profit and Loss Account and Cash Flow Statement of the Company for the year ended on that date, annexed thereto. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As required by the Companies (Auditor's Report) Order, 2003, issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the said Order.

Further to our comments in the Annexure referred to above, we report that :

(a) we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit;

(b) in our opinion, proper books of account as required by law have been kept by the Company so far as appears from our examination of those books;

(c) the Balance Sheet, the Profit and Loss Account and the Cash Flow Statement dealt with by this report are in agreement with the books of account;

(d) in our opinion, the Balance Sheet,the Profit and Loss Account and the Cash Flow Statement dealt with by this report comply with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;

(e) on the basis of written representations received from the directors, as on March 31, 2005, and taken on record by the Board of Directors, we report that none of the directors is disqualified as on March 31, 2005 from being appointed as a director in terms of Section 274(1)(g) of the Companies Act, 1956;

(f) in our opinion and to the best of our information and according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India;

(i) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 2005;

(ii) in the case of the Profit and Loss Account, of the profit of the Company for the year ended on that date; and

(iii) in the case of the Cash Flow Statement of the cash flows of the Company for the year ended on that date

for BSR & Co.
(formerly Bharat S Raut & Co.)
Chartered Accountants
S. Balasubrahmanyam
Partner
Membership No. 53315

Bangalore,
April 14, 2005

Annexure to the auditors' report

The Annexure referred to in the auditors' report to the members of Infosys Technologies Limited (the Company) for the year ended March 31, 2005. We report that :

1. The Company has maintained proper records showing full particulars, including quantitative details and situation of fixed assets.
   The company has a regular programme of physical verification of its fixed assets by which all fixed assets are verified in a phased manner over a period of two years. In our opinion, this periodicity of physical verification is reasonable having regard to the size of the Company and the nature of its assets. No material discrepancies were noticed on such verification.
   Fixed assets disposed off during the year were not substantial, and therefore, do not affect the going concern assumption.
2. The Company is a service company, primarily rendering information technology services. Accordingly it does not hold any physical inventories. Thus, paragraph 4(ii) of the Order is not applicable.
3. The company has neither granted nor taken any loans, secured or unsecured, to or from companies, firms or other parties covered in the register maintained under section 301 of the Companies Act, 1956.
4. In our opinion and according to the information and explanations given to us, there is an adequate internal control system commensurate with the size of the Company and the nature of its business with regard to purchase of fixed assets and the sale of services. The activities of the Company do not involve purchase of inventory and the sale of goods. We have not observed any major weakness in the internal control system during the course of the audit.
5. In our opinion, and according to the information and explanations given to us, there are no contracts and arragements the particulars of which need to be entered into the register maintained under section 301 of the Companies Act, 1956.

6. The Company has not accepted any deposits from the public.
7. In our opinion, the Company has an internal audit system commensurate with the size and nature of its business.
8. The Central Government has not prescribed the maintenance of cost records under section 209(1) (d) of the Companies Act, 1956 for any of the services rendered by the Company.
9. According to the information and explanations given to us and on the basis of our examination of the records of the company, amounts deducted / accrued in the books of account in respect of undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Income-tax, Sales-tax, Wealth tax, Customs duty and other material statutory dues have been regularly deposited during the year by the Company with the appropriate authorities. As explained to us, the Company did not have any dues on account of Employees State Insurance, Excise duty, Service tax and Cess.

   According to the information and explanations given to us, no undisputed amounts payable in respect of Provident Fund, Investor Education and Protection Fund, Income tax, Sales tax, Wealth tax, Customs duty and other material statutory dues were in arrears as at March 31, 2005 for a period of more than six months from the date they became payable.

   According to the information and explanations given to us, there are no dues of Income tax, Sales tax, Wealth tax and Customs duty which have not been deposited with the appropriate authorities on account of any dispute.
10. The Company does not have any accumulated losses at the end of the financial year and has not incurred cash losses in the financial year and in the immediately preceding financial year.
11. The Company did not have any outstanding dues to any financial institution, banks or debenture holders during the year.
12. The Company has not granted any loans and advances on the basis of security by way of pledge of shares, debentures and other securities.
13. In our opinion and according to the information and explanations given to us, the Company is not a chit fund or a nidhi / mutual benefit fund / society.
14. According to the information and explanations given to us, the Company is not dealing or trading in shares, securities, debentures and other investments.
15. According to the information and explanations given to us, the Company has not given any guarantee for loans taken by others from bansk of financial institutions.
16. The Company did not have any term loans outstanding during the year.
17. The Company has not raised any funds on short-term basis.
18. The Company has not made any preferential allotment of shares to companies / firms / parties covered in the register maintained under section 301 of the

Companies Act, 1956.

19. The Company did not have any outstanding debentures during the year.
20. The Company has not raised any money by public issues during the year.
21. According to the information and explanations given to us, no fraud on or by the Company has been noticed or reported during the course of our audit.

for BSR & Co.
(formerly Bharat S Raut & Co.)
Chartered Accountants
S. Balasubrahmanyam
Partner
Membership No. 53315

Bangalore,
April 14, 2005

5.14 Types of opinion / Types of Audit Report

There are four types of opinion that may be made by an auditor which are as follows :

1. Unqualified opinion

Where an auditor gives an opinion on the various matters without any comment or reservations, it is an unqualified opinion. In an independent financial audit unqualfied opinion implies that the auditor is of the opinion that the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India.

2. Qualified opinion

When an auditor gives an opinion that financial statements give a true & fair view subject to certain reservations, he is said to have given a qualified opinion. AAS 28 provides that–

A qualified opinion should be expresed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so meterial and pervasive as to require adverse opinion or limitation on scope is not so material and pervasive as to require a disclaimer of opinion. A qualified opinion should be expressed as being ‘subject to’ or ‘except for’ the effects of the matter to which the qualification relates.

3. Disclaimer of opinion

Where an auditor fails to obtain sufficient information to warrant an expression of opinion, he makes a disclaimer of opinion. Accordingly the auditor may state that he is unable to express an opinion because he has not been able to obtain sufficient evidence to form an opionion.

As per AAS 28, a disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is accordingly, unable to express an opinion on the financial statements.

(4) Adverse or Negative Opinion

According to AAS-28, an adverse opinion should be expressed when the effect of a disagreement is so meterial and pervasive to the financial statements that the auditor concludes that qualification of the report in not adequate to disclose the misleading or incomplete nature of the financial statements.

Thus, where an auditor concludes that based on his examination he does not agree with the affirmations to be made, he gives an adverse opinion.

Clause 41 of AAS 28 also provides that whenever the auditor express an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in agregate, on the financial statements should be mentioned in the auditors report.

5.15 Independence of auditors

It is fundamental to the whole concept of auditing that the auditor expresses an independent professional opinion on financial statements / accounts. Unless auditors are seen to be independent of the clients on whose accounts they are reporting shareholders and public at large cannot be exposed to place faith in their integrity and objectivity.

Guidance note on independence of auditor issued by ICAI is explained below :

Professional integrity and independence is an essential characteristics of all the professions but is more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him, or to his own self-interst. Independence is a condition of mind as well as personal character and should not be confused with the superficial and visible standards of independence which are sometimes improved by law. The code of ethics for Professional Accountants, issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows :-

"Independence is—

(a) Independence of mind—

The state of mind that permits the provision of an opinion without being affected by influenses that compromise professional judgement, allowing an individual to act with integrity and exercise objectivity and professional skepticism; and

(b) Independence in appearence—

The avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's integrity, objectivity or professional skepticism had been compromised.

In all phases of a Chartered Accountant's work, he is expected to be independent.

IFAC identifies five types threats to independence. These are :–

1. Self-interest threats

This occurs when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.

2. Self-review threats

This occurs when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client.

3. Advocacy threats

Which occurs when the auditor promotes or perceived to promote, a clients opinion to a point whose people may believe that objectivity is getting compromised.

4. Familiarity threats—

These are self-evident and occur when auditors form relationships with the client where they end up being to systematic to the clients interests.

5. Intimidation threats

Which occur when auditors are deferred from acting objectivity with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement order disagreements with the applications of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice. Following are important features of ICAI and Companies Act in respect of ensuring or creating the existence of independence :

(i) As per ICAI guidelines chartered accoutants are advised to apply a specific guideing principles. (like independent of the entities that they are auditing etc.)

(ii) As per Companies Act requirements :

* Disqualifications under section 226

* Passing of resolution in general meeting for appointment as per Section 314 of the Companies Act.

(iii) As per code of ethics under the CA Act, 1949 clause 10 of Part I of the First Schedule to the CA Act, 1949 prohibits acceptance of, what have been described as contingent fees i.e. fees which are either based or percentage of profits or otherwise dependent on the finding or the result of employment.

(iv) Clasue (H) of part I of second schedule to the CA. Act, 1949 provides that a practising Chartered Accountant shall be deemed to be guitly of professional misconduct if he expresses his opinion on financial statements of any business or any enterprise in which he, his firm or partner in his firm has a substantial interest, unless he disclose his interest also in his report.

(v) A member must take care to see that he does not get into situations where there could be conflict of interest and duty.

(vi) A CA in employment should not certify the financial statemets of the concern in which he is employed.

(vii) The council of the institute wishes to emphasise that clasue (4) of part I of second schedule to the CA Act, 1949 should be equally applicable to all types of audit function by the members (the special auditor, audit etc.)

(viii) The members are not permitted to write the books of accounts of their auditee clients.

(ix) A statutory auditor of a company cannot also be its internal auditor as it will not be possible for him to give independent and objective report with respect to CARO '03 under section 227 (4A) of the Companies Act.

(x) Apart from these, to ensure that the professional independence of a member doing attest function does not appear to be jeopardized he should as far as possible, take care to see the compliance of restrictions in respect of earnings of professional fees and rules regarding professional misconduct as per clause (8) and (9) of Part I of First schedule to the CA Act, 1949.

If the opinion of chartered accountant is to command respect and the confidence of the public, it is essential that they must ensure their independence to assure the public as regards faith and confidence that could be reposed on him, where he feels that independence is jeopardized he should refrain from accepting the appointment.

5.16 The True and Fair View

The expression "true and fair view" is central to auditing and yet it is an obstraction whose meaning is far from clear. It is an abstract idea of immense importance and dificulty.

The Companies Act states that every balance Sheet should give a true and fair view of the statement of affairs of the company at the end of financial year and every profit and loss account give a true and fair view of profit and loss of the company for the financial year [Sec. 211 (1) & Sec. 211 (2)]. The financial year implies accounting year of the company. Again subsection (5) of sec 211 implies that balance sheet and profit and loss of a company shall be deemed as not showing a true and fair view, if they do not disclose any matters which are required to be disclosed by the virtue of the provisions of schedule VI, any notification, any order of the central government. It is important to mention here that disclosure requirement as per Companies Act is the minimum requirements and if it is seen certain information is vital for showing a true and fair view. The financial statement must disclose it although no specific requirements were there thus as per the company law "truth and fairness" is a fundamental qualitative characteristics of financial statements.

The idea of truth and fairness involves a number of thoughts including

* Expectation
* Relevance
* Objectivity
* Freedom from bias
* Beyond simple conformity
* Compliance with GAAP
* Disclosure
* Understandability
* Reliability
* Comparability
* Materiality

The Directors Responsibility Statement is a step to ensure ''truth and fairness'' in the financial statements.

As per AAS 28, auditor's report must include an opinion as to whether the financial statements give a true and fair view in accordance with the financial reporting framework.

The Pharse 'true and fair view' in the auditor's report, thus signifies that the auditor makes an opinion as to whether the financial statements represent fairly the actual financial position at the end of the accounting period and profit and loss of that period. So, what constitute a true and fair view is a matter of an auditor's judgement in the particular circumstances of the case. However, the following guidelines may be used to judge the true and fair view :–

1. The balance sheet and profit and loss account must be drawn up in conformity with the requirements of the Companies Act, or other relevent Acts.

2. Relevant information must be disclosed and Balance Sheet and profit and loss account should state the actual positon i.e. no over or under statement and no window dressing in balance sheet and profit and loss account. There should not be creation of any secret reserve unless statements specifically permits that.

3. All meterial facts should be disclosed in respect of expenses, income, assets and liabilities and also there should not be any misstatement. Least-as good ideas to be avoided.

4. All unusual, exceptional or non-recurring items should be disclosed separately.

5. Balance Sheet and profit and loss account should be prepared and presented in conformity with the GAAP and that is to be followed consistently and in case of any departure fact alongwith the effect to be disclosed.

6. Post balance sheet events should be considered properly if the auditor thinks it necessary to do so.

7. The financial statements must convey the required information clearly to facilitate the quality of understandability and full disclosure. It is important to mention that it has been decided in many legal cases that information and means of information are by no means equivalent terms.

5.17 Concept of Materiality

The cencept of materiality is state of relative importance which varies from person to person. It is fundamental to the process of recognition, aggregation, classification and presentation of financial information which encompasses financial statements. It is an important consideration for the auditor who constantly has to judge whether a particular item or transaction is meterial or not.

The generation of materiality arises in many stages in the course of an audit. The auditor has to apply the concept of meteriality in the following situations :

a) while determing the nature, timing and extent of audit procedure;

b) while evaluating the effect of misstatements.

c) when mistakes are disclosed by the auditors in the accounting books and records i.e., calculation of depreciation, information of stock etc.

d) In disclosing the non-recurring and unusual itesm of income or expenditures.

e) In respect of treatment and disclosure of prior period items

f) Disclosure of items required as per law, statutes etc.

The related provisions in respect of materiality may be mentioned as fallows :-

1. Part II of schedule VI to the Companies Act, 1956 requires that every profit and loss account should disclose every meterial information affecting the working results to facilitate the objective of exibiting true and fair view of state of affairs and working results of the company.

2. AS 1, 'Disclosure of Accounting Policies', defines meterial items as the items knowledge of which might influence the decisions of the user of the financial statements.

3. AAS 6, 'Risk Assessments and Internal Control' also takes into consideration relationship between concepts of materiality audit risk, and internal control.

AAS 13, 'Audit Materiality' state that information is meterial if its misstatement could influence the economic decisions of the users taken on the basis of the financial inforamtion. Meteriality depends on the size and nature of the item, judged in the particular circumstances of its misstatement.

4. Clauses 5, 6, 8 and 9 of Part I of the second scheulde to the Chartered Accountants Act, 1949, refer to material fact, material misstatement, material exceptions and material departure from GAAP.

5.18 Divisible Profits and Dividend

5.18.1 Divisible Profit

The amount which can be distributed legally as dividend to the shareholders is called divisible profit. The following four considerations may govern the determination of amount of divisible profit :

1. Principle of accounting
2. Provisions of Memorandum and Article of Association
3. Provisions of the Companies Act (Section 205)

4. Legal decisions (Lee Vs. Neutchatel Asphalt Co. Ltd., Wilmer V. McNamara & Co. Ltd.)

5.18.2 Auditor's Duty regarding divisible profit

The auditor should take into consideratioin the following points while verifying the divisible profit of a company :

(1) Verification of amount of profit

(2) Verification of the provisions of the Companies Act regarding depreciation as mentioned in Section 205.

(3) Verification of the provision of income-tax.

(4) Examination of transfer to reserve (according to Companies Act and Article of Association)

(5) Verification of transfer of profit to Debenture Redemption Fund, if required.

(6) Treatment of writing off past losses.

(7) Consideration towards inclusion of information in audit report in respect of any contravention of all these formalities

5.18.3 Dividend

The portion of the divisible profit which is actually distributed to the shareholders is called dividend.

• Classification of Dividend

Dividend can be classified in the following ways :

(i) On the basis of source,
- a. Retained Earnings
- b. Current profit

(2) On the basis of medium of payments :
- a. Cash dividend
- b. Share dividend.

(3) On the basis of regularity of Payment :
- a. Interim dividend
- b. Annual (Final) dividends.

• Payment of Dividend

Dividend may be paid–

(i) Out of the current year's profit

(ii) Out of the profit of the past year

(iii) Out of both

(iv) Out of moneys provided by the Central Government or state government for the payment of dividend in accordance with any guarantee given.

• Interim Dividend

Dividend which is declared in between two AGM is called interim dividend. Article of association of a company must give power to Board of Directors to give such dividend and for which no general meeting is necessary.

• Final Dividend

After completion and preparation of financial statements Board of Directors of a company, following the Articles of Association, declares the final dividend and must be passed in the general meeting.

• Factors for declaration and payment of Dividend

Following factors to be considered by a company for declaration and payment of dividend.

A. Accounting aspects :

i) Depreciation (Sec 205)
ii) Past losses [Sec 205 (i)(b)]
iii) Provision for certain liabilities and tax.
iv) Transfer to reserve [Section 205 (2A)]
v) Contractual obligation (in case of loan)
vi) Dividend out of capital profits.
vii) Income Tax
viii) Dividend Tax if any.

B. Provisions of Companies Act

(i) Section 205 states the dividend can be paid only out of current or past profits or money received from any government for this purpose.

(ii) If there is unpaid capital, proportionate dividend should be paid on paid up capital (Sec-193).

(iii) Dividend always should be paid in cash except bonus shares [Sec 205 (3)].

iv) Dividend is to be paid either in cheque or by issuing dividend warrant [Sec 205 (5)(B)]

v) Dividend in cheque should be sent to the registered shareholders or to his order or to his bankers. (Section 205C)

vi) Dividend to be paid or warrant to be sent within 30 days from the date of declaration of dividend and if not, officer responsible, for this will be punishable by fine and imprisonment exceding 3 years excepting in the following cases :

a) Legal barrier
b) Impossible to do shareholders' instruction
c) Disputed case
d) Non-fault on the part of the company. (Sec 207)

vii) Unpaid dividend to be transfered to special dividend account within 7 days from the date of expiry of 30 days from the date of declaration of dividend if it is not paid by the company or claimed by the shareholders. (Sec 205A)

viii) Table A of Schedule I (Standard clause in Articles of Association)

Clause 85 : Rate of dividend in GM should never exceed the rate declared by BOD.

Clause 86 : Interim dividend may be paid in the BOD may think such payment to be reasonable.

Clause 87 : If reasonable the BOD may not paid dividend.

Clause 88 : No dividend will be paid on advance money receivable from shareholders.

Clasue 92 : In case of joint shareholding either of the parties may receive dividend by showing the receipt.

Clause 93 : Notice of dividend must be sent to the shareholders who are entitled to receive dividend.

Clause 94 : No interest can be paid on dividend.

Apart from these formalities an auditor should also look into the matter relating to compliance of FEMA Act, RBI Rules and Income-tax Act in respect of declaration and payment of dividend paid to shareholders residing outside India.

• Dividend and auditor's duty

Following factors should be considered by an auditor in respect of audit of dividend :

i) Examination of Articles of Association.

ii) Verification of sources of dividend.

iii) Review of Minute Book

iv) Verification of dividend register.

v) Examination of bank account in respect payment of dividend.

vi) Examination of payment of dividend with respect to its time limitation.

vii) Verfication of unclaimed dividend account to ensure proper transfer as per section 205A of the Companies Act.

viii) Examination of compliance of section 205A regarding transfer of profit to reserve [Rule 3 of Companies (Transfer of Profits to Reserve) Rules, 1975.]

ix) Examination of transfer of unclaimed amount in unclaimed dividend account to the General Reserve of the Central Government.

x) Verification of compliance of the rules contained in Table A.

xi) Verification of compliance of Companies Act, RBI Rules, FEMA Act, and Income tax requirements to the extent they are related to the declaration and payment of dividend.

5.19 Others

Also the payment of dividend out of capital profits, payment of interest out of capital (Sec. 208) are the important areas to be taken up by the students which requires knowledge of relevant provisions of the companies Act, ICAI guidelines, decisions held in many important legal cases and above all the business and accounting prudence.

5.20 Questions

1. State the provisions of Companies Act 1956 regarding qualification, disqualification of an auditor.
2. How is an auditor of a company appointed? State the provisions as to their removal and remunarations.
3. Explain the rights and duties of an auditor of a company.
4. Describe the contents of audit report.
5. What are specific matters to be considered by an auditor as per CARO '2003 under Companies Act.
6. State the factors to be considered for declaration and payment of dividend.
7. Write short notes :

a) Branch Audit b) Audit Cieling c) True & Fair view d) Independence of Auditor e) Concept of materiality f) Unclaimed dividend g) Interest paid out of capital h) Dividend paid out of capital profits.

Unit 6 ❐ Special Audit

Structure

6.0 Objectives

After studying this unit the student should be able to

- State the concept of Management Audit and Operational Audit and their purposes.
- Distinguish between Management Audit and Operational Audit.
- Explain the concept of Cost Audit and its benefits as well as the statutory requirements relating to that.
- Write the nature of forecast audit.
- Give ideas of limited review and other statutory requirements as per the listing agreement.

6.1 Introduction

In order to achieve the various organisational objectives effectively and efficiently the management introduces various controls, the whole of which is known as internal control. Whether or not internal control system is sufficient and adequate and is working effectively and efficiently, internal audit is made.

Management is a collective function in itself whether or not this function or activity has been working efficiently and effectively in achieving the organisational objectives that requires a specific reference to the experts in this field. Similar is the case in regard to operational part of the organisation. For verification of cost accounts and checking as regards adherence to the cost accounting plan cost audit is done. It ensures that cost statements are properly drawn up as per records and that they represent a true and fair view of the cost of production and marketing of the product under audit.

Clause 41 of listing Agreement requires that a listed company should furnish unaudited financial results on a quarterly basis which have to be subjected to a Limited Review by the auditor of a company.

All this has therefore evolved a concept of different types of audits. In this topic, thus, we should be discussing various aspects of Management Audit, Operational Audit, Cost Audit, Forecast Audit, Audit of Interim Financial Statements and Limited Review as required by listing agreement under SEBI.

6.2 Management Audit

6.2.1 Concept and Definition

Management audit deals with various aspects of the management process. It is an audit to examine, review and appraise the various actions and policies of the management on some standard basis.

The following definition may be noted :

"Management audit is a systematic, comprehensive, critical appraisal of the organisation, structure, management practice and methods conducted normally by external independent persons. Its primary objective is to motivate management to take action which will lead to increase efficiency and profitability of the organisation" (British Institute of Managament).

NATURE

Management audit is thus concerned with review and appraisal of total performance of management of the company. It is neither compulsory under any statute nor by any law but is purely voluntary and terms of reference and scope are determined by the management. This can be undertaken externally by management constultants or internally by management themselves. No specific qualification is prescribed for the management auditor. The area and scope of management audit are very wide and comprehensive and is an excellent tool of management control in various situations. It is an entirely new dimension to the audit function and has tremendous potential. It is mainly concerned with finding out the efficiency of the control system in operation. It reviews as to whether the policies laid down and decision taken were in organisation's interst and were effective. It involves a technique of assuring how effectively the management executives can plan, organise, direct and control efficiently and how effecitively they have been able to use the available resources for achieving the desired objectives.

6.2.2 Objectives

The objectives of management audit are as follows:

1. To assist all levels of management by keeping watch on all operations of the organisation.
2. To assess the management policies, their adequacy for proper performances and procedures adopted for further implementation of management policies.
3. To identify the areas which are responsible for low profitability and productivity, inefficiencies and ineffectiveness of management.
4. To recommend for improved human relation approach, new management development and overall organisational plans and objectives.
5. To assess whether the integrated management system to satisfy the obligations to the customers and society are being effectively implemented and the true and fair presentations of the results of such an examination.
6. To review the performance of the important management personnel.
7. To identify the cases and the persons responsible for the decisions resulting in heavy losses to the organisation thereby having its adverse impact on image, goodwill of the company and to take actions accordingly.

6.2.3 Need

Management audit is highly result-oriented and it can be useful in the following situations:

1. It may be conducted periodically to assess the performance of various management personnel and link a system of incentives with such an assessment.
2. Sometimes government may order a management audit with a view to assess the efficiency of the management of a company. For revivial of the company who are in various problems, goverment may ask for management audit and on getting report, government may take the following steps:
   a) Government may inject finance by granting subsidy.
   b) It may consider taking over the management.
   c) It may try to remove the constraints instead of taking the above steps.
3. A financial institution, bank may be interested in doing the management audit of a company before advancing loans or before agreeing to participate in the equity capital of an enterprise.

4. Foreign collaborators may also be interested in management audit conducted periodically as it would help them to assess the managerial abilities of their associates.

6.2.4 Steps in Management Audit

The steps taken to cover the entire scope of management audit are as under:

(i) Identification of the objectives of the organisation.

(ii) Segregation of the overall objectives of the organisation into detailed targets and plans for various segments.

(iii) Review of the organisation structure to assess whether it can achieve effectively the overall objectives.

(iv) Identification of specific responsibility centres in the organisation.

(v) Examination of the performance of each responsibility centre or functional area.

(vi) Submission of report on observations.

6.2.5 Techniques in Management Audit

The management audit requires an interdisciplinary approach since it covers review of all aspects of management function. In the process of conducting management audit, a management auditor can adopt and use a number of techniques of verificatory audit. This is primarily concerned with the appraisal of performances in the various ideas of management. In doing so, he can use the following techniques effetively:

(i) Inquiry

A management auditor may collect most of the evidence required by him by asking relevant questions and obtaining satisfactory answers to these questions.

(ii) Examination

In many cases, the management auditor conducts an examination of records and documents. It becomes necessary when the enquiry process yields certain information which needs colaboration or which suffers from internal contradictions.

(iii) Confirmation

A management auditor may also obtain written or oral statements from various persons in order to confirm the information obtained by him.

(iv) Observation of pertinent activities and conditions

In many cases, the management auditor may have to rely upon his own observation of pertient activities and conditions in the organisation. A management auditor may prepare organisational charts and flow charts as a result of his observation of pertinent activities and conditions.

(v) Correlation of information

The information collected through the various techniques has to be correlated so that proper conclusions can be drawn. The management auditor has to compare the actual performances with the standards laid down or with the performances in the previous years. A good deal of skill is required in correlating the relevant information so as to reach meaningful conclusions.

6.3 Operational Audit

6.3.1 Concept and definition

An operational audit is an organised search for ways of improving efficiency and effectiveness. In today's highly competitive business environment, the demand for operational audits can be attributed to management's desire to increase revenues, increase productivity, and reduce costs. Operational auditors search for ways to reduce waste and ineffeciency. Many corporate restructurings reported in the business process are the results of operational audits.

The Federal Financial Officer's Institute in Canada has defined Operational Audit as "a systemetic independent appraisal activity within an organisation for a review of the entire departmental operations as a service to management. The overall objective of operational auditing is to assist all levels of management in the effective discharge of their responsibilities by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed".

The American Institute of Certified Public Accountants (AICPA) defines operational auditing as "a systemetic review of an organisation's activities or a stipulated segment of them in relation to specified objectives for the purposes of assessing performances, identifying opportunities for improvement, and developing recommendations for improvement or further action".

A review of a company's computerised accounting system, assessment of its efficiency and reliability, and recommendations for improving the system would constitute an operational audit.

6.3.2 Nature and Purpose

Operational audit is primarily concerned with finding out whether all operations of the business in the areas of purchase, storage, transportation, manufacturing, quality control, marketing, financial services etc. are being carried on properly. It involves a systematic approval of the effectiveness of major functions of an organisation against corporate and industry standards and norms and theory identifying the areas where improvements can be made.

The purpose of operational audit is the following:

(1) To assure the management that operational objectives are valid and operational control information is valid and reliable.

(2) To assure that the operational activities are effective and efficient.

(3) To measure the efficiency of any operation by measuring output in relation to input is given below:

$$\text{Efficiency} = \frac{\text{Output (Effectiveness)}}{\text{Input (Economy)}}$$

6.3.3 Benefits

A properly conducted operational audit should provide management with a number of benefits, including

(i) Increased Pofitability

(ii) More efficient allocation of resources

(iii) Identification of problems at an early stage, and

(iv) Improved communications.

6.3.4 Steps in Operational Audit

Following steps should be taken in conducting an operational audit:

(i) Acquainting himself with techniques of the operations

(ii) Familiarisation with the actual operations and operating problems.

(iii) Analysis and appraisal of the control systems being followed in that area of activity.

(iv) Examination of adequacy of controls being exercised in the conduct of the activity.

(v) Recommendation to avoid defects or to remove lacunae in the operating areas.

(vi) Reporting.

6.4 Cost Audit

6.4.1 Meaning and objects

Cost audit refers to the verification of cost accounts and a list on the compliance to the cost accounting plan. It involves :

(i) The verification of the record of cost accounts like the accuracy of the cost accounts, costing techniques and cost reports.

(ii) Scrutinising these records to make sure that they adhere to the cost acounting principles and objectives.

According to the Institute of Cost and Works Accountants of India cost audit can be defined as “Verification of the correctness of cost accounts and adherence to the cost accounting principles, plans and procedures”.

In our country cost audit was introduced in the year 1965, with the objective of providing complete information as to the efficiency of management and overall productivity of the factors of production.

Section 233B was incorporated in the Companies Act, 1956 by the Companies (Ammendment) Act, 1965 to provide for statutory cost audit in the case of specified companies. Cost audit is in addition to the financial audit conducted under section 224 of the Companies Act.

The main objective of cost audit is to

(i) help improve industrial efficiency all round and maximum production

(ii) make the general public cost conscious

(iii) pave the way towards its introduction in all organisations as is in advanced countries.

(iv) ensure that cost statements presents ture and fair view of the cost of productions and marketing the 'product under audit'.

It has some social objective also. They are as follows:

(i) To protect the interest of the shareholders

(ii) To produce quality goods at a reduced price

(iii) Controlling inflationary trend.

6.4.2 Importance

Cost audit is an effective tool of control in the hands of management and also is considered to be a check on behalf of the shareholders, the consumers, and the government. It identifies weaknesses in the cost accounting system and disclose inefficiences in all levels of organisation.

It is also necessary from the point of view of the consumers and the government. It helps the government in deciding whether or not tariff protection should be extended. The government may depend upon the audited cost statements to fix proper prices under a scheme of price control. Audited cost statements may be useful in keeping tax or duty based on the cost of products.

Audited cost statements may also be used by associations of various industries to setup standard costs against which individual firm may compare their actual cost figure. It plays an important role in the context of price controls and shortages in the economy. It helps in fixation of prices, assessment of tax, settling trade disputes.

6.4.3 Advantages of Cost Audit

Cost audit is immensely advantageous to the government, society, management and shareholders of the company.

A. To the Government

(i) It helps the government in fixing prices of essential commodities. It facilitates a check on undue profiteering and assessment of tax.

(ii) It helps to identify the inefficient units and take appropriate action for their survival.

(iii) It facilitates settlement of trade disputes.

(iv) It helps in bringing healthy competition amongst units in industry thereby controls inflationary trends.

B. To the Society

(i) Reasonable price increase is allowed due to increase in cost of production and thus consumers can maintain their standard of living.

(ii) Consumers are protected from exploitation. Since prices are fixedup on the basis of reliable and correct cost data the consumers are saved from any exploitation.

C. To the management

(i) It provides management reliable data for its day-to-day operations like price fixing, control, decision making, etc.

(ii) It helps to identify the inefficiencies in the working of company and thereby assists management in taking corrective action.

(iii) It facilitates management by expertise.

(iv) Control tools like standard costing and budagetory control will be facilitated.

(v) A continuous vigil on all workers can be maintained through an adequate and proper system of reporting to the management.

(vi) Inventory valuation can be done with great accuracy.

(vii) It is very much effective in detection of errors and fraud.

D. To the Shareholders

(i) It ensures shareholders a fair return on their investment.

(ii) It makes sure that proper records are kept for purchase and usage of materials and sales are not made below its cost in normal circumstances.

6.4.4 Provision Regarding Cost Audit

(a) Under Section 233B of the Companies Act, the central government may direct by an order that an audit of the cost records maintained by a company under section 209(1)(d) shall be conducted by a Cost Accountant in such manner as may be specified.

(b) Section 209 of the Companies Act, 1956 empowers the central government to make it compulsory in the case of specified classes of companies to maintain cost records.

(c) Cost audit shall be in addition to statutory financial audit conducted Under Section 224.

(d) The cost auditor shall be appointed by the Board of Directors of the company with the prior approval of the central government. The board of directors should obtain a written certificate pertaining to compliance of provisions of Section 224(1B) from the proposed cost auditor.

(e) A firm of cost accountants can be appointed as cost auditor if all the partners of the firm are practising cost accountants and the firm itself has been set up with the previous approval of central government as required by ICWA Act 1959.

(f) A person cannot be appointed as cost auditor if he attracts any of the disqualifications mentioned in sub-sections (3) and (4) of Section 226 of the Companies Act.

(i) A body corporate.

(ii) An officer or employee of the company.

(iii) A person who is a partner, or who is in the employment, or an officer or employee of the company.

(iv) A person who is indebted to the company for an amount exceeding Rs.1000 or who has given any gurantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees.

(v) A person who holds any voting shares of the company.

(vi) A person cannot be appointed if he is disqualified to be the cost auditor of its subsidiary or holding company, or another subsidiary of its holding company.

(vii) A person appointed as an auditor of a Company under section 224.

(g) The board of directors on receipt of the order from the central government passes a resolution either at a meeting or through circulation appointing a cost auditor, subject to the approval of the central government. On getting the application the central government communicates its approval to both the company and the proposed cost auditor. After that a formal letter of appointment is then issued to the cost auditor by the company.

(h) The company should provide all facilities and assistance to the person appointed as cost auditor.

(i) The cost auditor has the same powers regarding cost audit as an auditor of a company has under Sub-Section (1) of Section 227.

(j) As per Rule 6 of Cost Audit (Report) Rules, 2001 the company and all of its officers should provide all cost accounting records, statements and other required books and documents within 135 days from the end of relevant financial year.

(k) The cost auditor should submit his report to the central government (one hard copy and a soft copy) in the prescribed format and simultaneously send a copy of the report to the company within 180 days from the end of the company's financial year to which the report relates.

(l) The company has to furnish to the central government full informations and explanations on every reservations or qualification contained in the cost audit report, within 30 days from the date of receipt of the copy of the report.

(m) On receipt of further information and explanation furnished by the company, the central government may take necessary action on the report in consonance with the provisions of the law in force.

(n) The central government may direct the company to circulate the whole or such portion of the said report to its members, along with the ntoice of the AGM to be held immediately after the submission of such report.

(o) In case of non-compliance of the provisions, the company shall be liable to be punished with fine which may extend to five thousand rupees and every officer of the company who is in default, shall be liable to be punished with imprisonment for a term which may extend to three years or with fine which may extend to five thousand rupees, or with both.

(p) A cost auditor can attend and participate in the meetings of the Audit Committee constituted Under Section 292A 'in his capacity as internal auditor' without voting rights.

6.5 Forecast Audit

6.5.1 Concept and Definition

Several types of audit have been discussed earlier like financial audit, cost audit, internal audit, management audit and operational audit etc. It signifies its wide range of application in various operational fields. Therefore the term audit may be claimed to have attained multidimensional approaches. Now the time has come when the services of auditing professional is not only confined to examination of the past happenings but are expected to extend in attending the forecast of profit made by management. People are not only interested to invest money on the result of the past performance but they are also interested in the information as regards forecast of profit made by the management Thus the concept of forecast audit has emerged. Forecast audit may be defined as a critical examination and review of the forecast of profit, sales, earnings and cost of the business, made by the management for the general understanding of all those who are interested in the affairs of the business, by applying reasonable skill, care and judgement.

6.5.2 Benefits

Forecast audit has the following advantages :

1. Continuity of business can be ensured by regular check up of the different key areas of the accounting process.
2. It can strengthen the integrity of the capital structure of the business.
3. Business can go for various dynamic strategies well in advance to face the future uncertainties.
4. It helps the prospective investors to make the best investment decision.

6.5.3 Procedures of Forecast Audit

The following procedures may be followed for conducting the forecast audit :

1. Examining the nature background and environment of the business.
2. Scruitinising the different activities of the business and its products.

3. Ensuring of compliance of the generally accepted accounting principles (GAAP).

4. Verification of the assumptions upon which the profit forecast is based with reference to the economic, commericial, marketing and financial strategy of the company.

5. Verification of accounting treatment made in respect of specific items like research and development expenditure, taxation, foreign currency translation and other unusal, exceptional items.

6. Examining the procedures and methods employed for preparing the forecasts and to verify that the forecasts are based on consistent accounting policies.

7. Reviewing the materiality of important information and figures used for the forecast with reference to its reliability and authenticity.

8. Verifying the degree of accuracy of different figures that are taken into consideration for preparing the forecast.

9. Ensuring that provisions have been made properly for all contingencies.

10. Verifying the adquacy of provision for working capital and the long term finance.

11. Confirming through interview with the respective officials that all relevant post happenings and expected events likely to have effect on the business have been taken into considerations while preparing the forecast.

12. Examining the basis of sales forecast and satisfying that it is based on efficient market study.

13. Verifying the competenery of the persons involved in the preparation of forcast.

14. Examining whether the adjustments of exchange rate fluctuations are given due weight in the preparation of forecast.

15. Verifing the adequacy of electronic devices, if any, adopted for the purpose of making the forecast.

6.5.4 Problems of Forcast Audit

Following are the problems that may be faced by the auditor in the conduct of forecast audit.

Ambiguity in the clients instruction towards liability of the auditor.

2. Insufficiency of information or documents for verification.

3. Difficulty in the judgement of materiality concept relating to an item included in the profit forecast.

4. Inherent risk of audit is high.

5. Assumptions made for forecast may not be satisfactory as it varies man to man and circumstances to circusmtanes.

6. In true sense accurate forcasting are never possible.

6.5.5 Comparison between Audit of Annual Accounts and Forecast Accounts

Differences between audit of annual accounts and the audit of forecast accounts may be summarised in the following lines :

1. The auditor conducts the audit of accounts based on past happenings while in the audit of forecast accounts the auditor considers the accounts based on future events.
2. In the audit of annual accounts audit work approaches through the books of accounts but in case of forecast accounts audit work approaches through the evaluation of the administrative controls.
3. In case of annual accounts audit report is realistic where as in case of forecast accounts the audit report is to some extent unrealistic.
4. In the former case the liability of the auditor is clearly defined but in the latter it is not possible to fixup the liability of the auditor.
5. In the auditor of annual accounts the use of the phrase ‘true and fair view’ in the audit report justify the propriety of happenings and the risk factor is minimum. But in the audit of forecast accounts the auditor cannot certify the uncertainties as being true and fair and also it involves greater amount of risk.
6. Audit of annual accounts is done mainly based on supporting documents but no such supporting documents are available in the case of audit of forecast accounts rather the auditor has to study the feasibility of different budgets and another information upon which forecast is based.

6.6 Audit of Interim Financial Reporting

6.6.1 Introduction

In refers to the audit of interim financial reporting. Interim financial reporting means financial reporting for a period which is shorter than a full financial year. It enhances the timeliness of the information and improves the ability of investors, creditors and others to take appropriate, economic decisions relating to reporting enterprise.

6.6.2 Definitions

As per Accounting Standard 25, ‘INTERIM FINANCIAL REPORTING’, it means a financial report containing either a complete set of financial statement or a set of condensed financial statement for an interim period which is shorter than full financial year.

Recognising this, clause 41 of listing agreements under SEBI requires the listed companies to publish quarterly financial results in the prescribed format.

6.6.3 Financial Statements

A complete set of financial statements generally includes–

1. Balance Sheet
2. Statement of Profit and Loss accounts.
3. Cash flow Statements.
4. Notes to Accounts and Accounting policies.

6.6.4 Objective

The objective of this standard is to prescribe the minimum contents of Interim Financial Report and the principles for recognition and measurement in a complete or condensed financial statement for an interim period.

6.6.5 Minimum Components of Interim Financial Report

An interim financial report should contain at least the following components :

1. Condensed Balance Sheet.
2. Condensed Profit and Loss Account.
3. Condensed Cash Flow Statement.
4. Selected Explanatory Notes.

An enterprise may present a complete set of financial statements. In case of complete set of financial statements it should be prepared as per the requirements of annual financial statements. However, a condensed interim financial report should include the following minimum information.

1. Headings and sub-totals that were included in the most recent annual financial statements.
2. Selected explanatory notes.
3. Additional items or notes the absence of which may make the reporting misleading
4. Basic and diluted earning per share for the interim period as per AS 20.

6.6.6 Principles of Recognition and Measurements

According to this standard there may be two distinctive principles of recognition and measurement of income and expenses in interim financial reporting :

- Integral view—An approach to measuring interim period income by viewing each interim period as an integral part of the annual period. Expenses are recognised in proportion to revenues earned through the use of special accruals and deferrals.
- Discrete view–An approach to measuring inteirm period income by viewing each interim period separately.

6.6.7 Minimum Disclosure of Notes

The Standard requires the disclosure of the following minimum information through notes and explanatory statements.

(a) A statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or if those policies have been changed, a description of the nature and effect of the change.

(b) Explanatory comments about the seasonality of interim operations.

(c) Unusual factors that affected assets, liabilities, equity, net income and cash flow.

(d) Effect of change in estimates

(e) Change in debt and equity through insurance, repurchase and repayments.

(f) Details of dividend payments

(g) Segment revenue, segment capital employed and segment results for the business segments in geographical segments, whichever is the primary basis of the reporting entity.

(h) Material event that occured after the end of interim period.

(i) Effect of changes in composition of the enterprise during interim period such as amalgamation, aquisition, restructuring, disposal of subsidiaries etc.

(j) Mateiral changes in contingent liabilities since the last balance sheet data.

6.7 Limited Review

A listed company, as per clause 41 of the listing agreement, has to furnish unaudited financial results on a quarterly basis in the prescribed format within one month from the end of each quarter to the Stock Exchange and also publish the same. The unaudited quarterly results have to be approved by the board of directors / its Sub-Committee and signed by the managing director / director. The quarterly results have to be subjected to a Limited Review by the auditor of the company and a copy of the Review Report has to be submitted to the stock exchange within two months after the close of the quarter. It may be noted that instead of publishing unaudited results wihtin one month followed by a Limited Review within two months, a listed company has the option to publish audited quarterly financial results within two months after the end of the related quarter.

6.8 Certificate on Corporate Governance

Clause 49 of the Listing Agreement requires that a listed company should comply with certain conditions of corporate governance as provided in that clause and should obtain a certificate from its statutory auditor as regards compliance thereof. This certificate is annexed to the Director's Report and must be sent to the stock exchange along with annual return.

6.9 Certificate on Cash Flow Statement

Clause 32 of the Listing Agreement requires that a company listed on a stock exchange has to give a cash flow statement also along with the balance sheet and profit and loss account and has to obtain a certificate from its statutory auditor relating to that. The cash flow statement has to be prepared in accordance with the indirect method as provided in AS-3. Asper AS-3, w.e.f., 14.2004, cash flow statement is attached with the balance sheet and profit & loss account and auditor gives reference of the some in this audit report.

6.10 Consolidated Financial Statements

Clasue 32 of the Listing Agreement requires a company listed on a stock exchange has to furnish a consolidated financial statements only audited by the statutory auditors in its annual report. The consolidated financial statements are in addition to the stand-alone financial statements of the parent company.

6.11 Questions

1. What is management audit? What are its objectives ?
2. State the techniques of management audit.
3. What is operational audit?
4. Describe the purpose and benefits of operational audit.
5. What steps do you consider necessary for conducting operational audit.
6. What is cost audit? State the provisions of the companies act relating to such audit. What are its advantages?
7. What is forecast audit? State the procedures of such audit?
8. Make out a distinction between audit of annaul accounts and audit of forecast accounts.
9. Write explanatory notes on the following :

a) Audit of interim financial reporting

b) Limited review.

c) Certificate on corporate governance.

Unit 7 ❐ Auditing in EDP Environment

Structure

7.0 Objectives

After reading and studying this unit the learners should be able to

- State the concept of EDP and its characteristics.
- Write the need for review of internal control under EDP system of accounting.
- Prepare the audit programme under EDP system
- Interpret the implication of computers for auditors.
- Explain about computer assisted audit techniques.

7.1 Introduction

With the advent of computers all business organisation are increasingly using computer for data processing. Computerisation generally affects organisation, controls, flow of documents and manner of information processing. It must always be appreciated that whatever method of data processing an enterprise uses, the basic objects of the audit are unchanged. Therefore, when a computer system is audited the duties and responsibilities of the auditor are exactly the same as if data were processed by manual or mechanical system. This unit, thus, deals with the development of EDP system of accounting and the major implications involved in auditing in a EDP environment.

7.2 Electronic Data Processing System (EDP System)

Electronic data processing (EDP) system denotes the use of digital computers and other data processing machines having electronic input for the purpose of collecting, sorting, analysing all types of information which signifies efficient conduct of business operations. It has revolutionised the accounting and control methods of business concerns in recent years. The main characteristics of EDP system are as follows :

- High Speed.
- Storage of huge information
- Advance software technology
- Accuracy
- Easy feed back
- Flexibility

7.3 Auditing in a Computer Environment

Audits should be executed in accordance with the auditors operational standard and with the guidance of the auditing guidelines. This is true of all audits including those of clients who have computerised accounting records. The basic approach to an audit is the same for all audits. However, there are some features of computerised systems which make it necessary to change some of the details of audit approach.

The auditor has to adapt himself to this revolution. However, it must be emphasised that the auditors duties remain same whatever the data processing are used.

7.4 Techniques of audit under EDP environment

The approach techniques adopted by auditors can be–

(a) **To Audit Round the Computer :**

This means treating the computer as a 'black box'. The auditor works at input and output but ignores what goes on in between. In this situation a substantive testing approach with analytical review is likely to be the most effective and economical method of listing.

(b) **Systems Evaluation :**

This has been seen as the best modern method for all audits but it does require the auditor to be well trained in EDP. The auditor will need to make detailed contact with the hardware and, with more difficulty the software.

In facts controls are strong enough to be relied on in very few systems. Therefore, the time spent on a detailed review of a system may be unproductive. However, some understanding of every system is necessary if the auditor is to have evidence that the organisation has maintained proper accounting records.

(c) Using the computer :

This means using :

(1) Established techniques such as test packs and computer audit programmes.

(2) Specially designed tests to be incorporated in the clients own processing. This will be necessary as real time systems become more common. They are known as embedded audit facilities.

7.5 Specific Problems of EDP audit

The auditor has to face the follwing special problems in relation to audit of computer systems.

(1) Much important information is held for long periods in non-visual form on storage devices, such as magnetic tapes and discs.

(2) The processing of data is carried out within the computer under the instruction of programs which are themselves in non-visual form and in computer language.

(3) The final visual output is often separated by a number of processing routines from the original input.

(4) These is often lack of audit trail, Audit trails means to trace any transaction sequentially through the system from their source to their completion and vice-versa.

(5) Computer systems can have programmed or automatic controls. It operation is difficult to check by an auditor.

(6) Clients may use an outside agency–a computer bureau—to maintain the accounting

records. This create considerable problems for an auditor in examining controls and systems where access is not a legal right.

7.6 Need for review of Internal Controls in EDP system of accounting

It is of course absolutely standard audit practice to begin by ascertaining, recording and evaluating the system of internal control, and this is even more important with computer systems, because of their complexity, than with other systems. The evalution of the system of internal control is most essential and considered to be the primary phase of audit in EDP system of accounting. The auditor, examines the design of internal control systems and also verifies how its actual workings corresponds to what was planned. This enables him to evaluate the reliance that can be placed on the processing system in producing reliable output. Since much controls are vital from the audit point of view, it would be highly appreciated if the management consults the auditor at the time of installation of electronic data processing devices in the accounting system. The active involvement of the auditor at the initial stages would help both the auditor and the management, to understand each others requirements and correlate them with the capacity of the system.

7.6 Internal Control in EDP System of Accounting

Important controls that should normally be found in a computer-based accounting system are :

a) Administrative control
b) Systems development control
c) Procedural controls (Controls over the processing of data)

Administrative control

It includes division of responsibilities, control over computer operators, file control and fire precautions and stand by arrangements.

Systems development control

This includes the following :

(i) Standard procedures and documentation
(ii) Systems and programme listing
(iii) File conversion
(iv) Acceptance and authorisation procedures
(v) System and programme amendments.

Procedure controls

This denotes the controls over processing of data which are of two types, namely, standing data and transaction data.

The procedural controls encompases the following controls :

(i) Input controls

(ii) Processing controls

(iii) Output controls

(iv) Master file controls

It may be emphasised that control over data is a continous process and the general overall aspect must be considered when dealings with any particular aspect.

7.7 Audit Implication of Computer aided auditing

The consequences for the auditor in computer aided auditing may be summarised as follows :

1. Knowledge and experience :

Technical knowledge and practical experience on the part of audit staff are an essential accompaniment to the planning and execution of all audit procedures. This may be gained from books, by attending courses, on-the-job training and by appointing computer technician to join the audit compliment.

2. Audit documentation

The documentation on the audit files must reflect the nature of the audit. Standard questionnaires and checklists must be redrafted accordingly, and the current files contain a record of all the client's EDP documentation, details of major controls included in the programmes, flow diagram of the systems etc.

3. Timing of tests

The auditor requires a totally revised approach to the timings of audit tests. When a complete and permanent record of all transactions, assets and liabilities is available at all times, audit rests on the records may be carried out at any convenient stage, by mutual agreement between client and auditor. In EDP systems, however, contemporary, as opposed to historical, testing is often an inescapable imposition.

4. The incidance of audit tests

Conventional records may be audited by vouching and checking the visible entries made at the very interface between the authorised and valid orginating documents, on the one hand, and the books of account, on the other. In EDP systems the recording counterpart takes place within the machine and no equivalent record is left for subsequent individual verification. For this reason the auditor is forced to shift the target of his tests, and to concentrate his effects on the following :

(a) Quality control over every stage in the creation of the input.

(b) The systems development control responsible for ensuring that the programmes function correctly.

(c) The administrative controls which are designed to ensure that the correct programmes are always used; that the staff observe designated job divisions, that hardware and files are physically secure and adequately secured by reconstruction and stan by facilities.

(d) The use made by managements of input records, particularly exception reports, and the control procedures governing rejection of invalid data.

(e) The need for this shift of incidence is understood when one realises that all tests 'through' the machine can, at best, provide indirection affermation on program functioning and although clearly better than nothing, such tests are always inferior, from the audit veiwpoint, to tests in which the accounting units may be scrutinized in their totality at the very point of their creation.

7.8 Computer Audit Programs

The auditors can use specifically written computer programmes to assist them with their audit. These can be used both to test the system of internal control and to assist the auditors with their balance sheet and profit and loss account verifications. The programme could have been specifically written by the auditor for use on particular client's computer, however, this is expensive and also requires considerable technical expertise. Therefore it will often be a generalized programme.

7.9 Auditing in a Computer Information System Environment (AAS 29)

The purpose of this Auditing and Assurance Standard is to establish standards on procedures to be followed when an audit is conducted in a computer information systems (CIS) environment.

Inportant features :

Following are the important features as stated by this standard :

1. The overall objective and scope of audit does not change in CIS environment.
2. The auditor should consider the effect of CIS environment on the audit.
3. The auditor should have sufficient knowledge of the computer information systems to plan, direct, supervise, control and review the work performed. In case of need, the auditor may seek the assistance of an expert prossessing the requisite skills.
4. The auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and to determine the nature, timing and extent of the audit procedure.

5. In planning the portions of the audit which may be affected by the CIS environment, the auditor should obtain an understanding of the significance and complexity of the CIS activities and the availability of data for use in the audit.

6. When the computer information system are significant, the auditor should also obtain an understanding of the CIS environment and whether it may influence the assessment of inherent and control risks. The nature of the risks and the internal control characteristics in CIS environments include the following :

- Lack of transaction trails.
- Uniform processing of transactions
- Lack of segregation of functions
- Potential for errors and irregularitis
- Initiation or execution of transactions
- Dependence of other controls and computer processing
- Potential for increased management supervision
- Potential for the use of computer-assisted audit techniques.

7. The auditor should make an assessment of inherent and control risks for natural financial statement assertions.

8. The auditor should consider the CIS environment in designing audit procedure to reduce audit risk to an acceptably low level.

9. The auditor should document the audit plan, the nature, timing and extent of audit procedures performed and the conclusions drawn from the evidence obtained. If audit evidence exists in electronic form, the auditor should satisfy himself that such evidence is adequately and safely stored and is retrievable in its entirety as and when required.

7.11 Questions

1. What do you mean by EDP system?
2. Explain the audit techniques used in EDP environment.
3. State the need for review of internal controls in EDP system of accounting.
4. Mention the specific problems of EDP audit.
5. Explain in detail the internal control system in EDP environment.
6. Describe the audit implication of computer aided auditing.
7. State the important features of AAS 29 in respect of auditing in computerised environment.
8. Write Short notes :
   a) Computer audit programmes
   b) Audit trails.

Unit 8 ❐ Professional Ethics and Code of Conduct

Structure

8.0 Objectives

After reading and studying this unit the student should be able to

- State the meaning of the term ‘Professional Ethics’.
- Distinguish between Professional Misconduct and Professional negligence.
- Describe the code of conduct prescribed by the ICAI. (The Institute of Chartered Accountants of India).
- Write the procedure to be followed to maintain and enhance the quality of audit.
- Highlight the emerging issues of audit in the present day context.

8.1 Introduction

Auditing is carried out by accountants in public practice. Accountancy is a profession. Professions have certain characteristics including an ethical code and rules of conduct. Professional accountants are required to observe proper standards of professional conduct whether or not the standards required are written in the rules or are unwritten. They are specifically required to refrain from misconduct resulting in discredit on himself, his professional body or the profession generally.

This unit, thus, is mainly concerned with the professional ethics, codes of conduct as prescribed by the professional bodies. It also includes discussion about the emerging and dynamic issues in audit alongwith the standard prescribed for maintaining and enhancing the quality of audit.

8.2 Profession

Dictionaries define and describe a profession as a calling or vocation involving some branch of learning. Clearly accountancy does involve a body of knowledge as is well known to students who are endeavouring to acquire it.

The idea of a profession rests of the following premises:

a. recognisable discreate body of knowledge.
b. an educational process.
c. a system of examinations.
d. a system of licensing practitioners.
e. a professional association.
f. a sense of responsibility to society.
g. a code of ethics.
h. a set of technical standards.

All of these premises can be applied to the accountancy profession.

8.3 Professional Ethics

8.3.1 Importance

A trademark of professionals is their willingness to accept a set of professional and ethical principles and follow these principles in the conduct of their daily affairs. The acceptance of these principles require that professionals maintain a higher standard of conduct than is called for by law. Professionals are required to consider carefully the implications of alternative actions and to conduct themselves in a manner that is not only lawful but proper.

Ethical conduct by members of professions is highly valued in our society. Codes of conduct, codes of ethics and canons of law provide ample evidence of these values. Even without codes and canons, professionals should feel a strong objection to act ethically because it is in the best interests of both themselves and society.

The Chartered Accountants occupy an important position in the financial sector of the country. In fact they are ensure that enterprises and organisations audited by them maintain adsolute transparency so far as their financial transactions are concerned. The need for transparency arises because it is only with transparency there would be accountability.

The increasing pace of globalisation and the integration of the Indian economy with the global economy is also bringing about a paradigm shift in the acounting standards practised by Indian enterprises. Probably the globably accepted accounting practices will become the norm in the country very soon. As India integrates more closely with the global economy it is necessary that the principles of corporate governance, which basically focus on transparency, acountability and creation of value for the stakeholders are effectively practised. It is here that the Chartered Accountants have a very important role to play. Through their practice of the profession, they must ensure that the standards of business ethics are maintained at the highest level not only by them as professionals, but in the enterprises audited by them. Rabindranath Tagore said that only a lighted candle could light another candle. Only ethically strong Chartered Accountants can ensure that the Indian business enterprises also practice the highest standards of business ethics.

8.3.2 Concept and Definitions

Professional ethics refer to the basic principles of right action for the members of a profession. It signifies the behaviour of a chartered accountant (professional) towards his felows in the profession and other professions and towards members of the public.

A few important definitions are given below:

As per American Heritage Dictionary professional ethics may be defined as "the study of the general nature of morals and of the specific moral choices to be made by the individual in his relationship with others". The choices we make determine our ethical values and the image we project to others.

“Professional ethics may be regarded as a mixture of moral and practical concepts, with a sprinkling exhortation to ideal conduct designed to evoke right action on the party of the members of the profession concerned. (Carey and Daherty)

The professional ethics aims at curbing the selfish interest of the professional accountants and thus to arouse their goodness in order to serve the society by accepting those areas of responsibility which goes beyond what the law demands. (Sould Levy)

The International Federation of Accountants (IFAC) recognises that the distinguishing characteristics of a profession include

- Adherence by its members to a common code of values and conduct.
- Acceptance of a duty to society as a whole.
- Accountancy profession has also the responsibility towards, ‘credit grantors, governments, employers, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of the professional accountants to maintain the orderly functioning of commerce.

According to IFAC the following to be the fundamental principles by which an accountant should be governed in the conduct of his professional relations with others.

Integrity

A professional accountant should be straightforward and honest in performing professional services.

Objectivity

A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.

Independence

The auditor should maintain an impartial attitude and both be and appear to be free of any interest that might be regarded, whatever its actual effect, as being incompatible with integrity, objectivity and independence. The auditor should be independent in fact and appearence.

Confidentiality

The auditor should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

Professional competence and due care

In agreeing to provide professional services, the auditor implies that a certain level of competence is necessary to perform professional services and that the knowledge, skill and experience of the auditor will be applied with reasonable care and diligence. Auditors should therefore refrain from performing any services that they are not competent to carry out useless advice and assistance are obtained to ensure that the services are performed in a satisfactory manner. An auditor should perform professional services with due care, competence, and diligence. He or she has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.

Technical Standards

An auditor should carry out professional services in accordance with the relevant technical and professional standards. Auditors have a duty to carry out, with care and skill, the instructions of the client or employer insofar as they are compatible with the requirements of integrity, objectivity and independence.

8.4 Code of Conduct

Most professions have written codes of professional conduct and there is a general commonality among them.

1. Members of each profession are usually expected to maintain a higher standard of conduct than is required by law.

2. The principles, codes and canons of each profession are usually designed to encourage ethical conduct and project a positive image to the public.

3. Professions also expressly prohibit certain acts on the part of their members. These acts are not compatible with the ethical standards that ensure quality work, clients' trust, and a positive public image.

The introduction to code of ethics of the Institute of Chartered Accountants of India states: "For the success of the profession of accountancy a self-imposed code of ethics is essential to command the respect and confidence of the general public. Chartered Accountants in the service of the affairs of others have responsibilities and obligations to those who rely on their work".

The conduct of the member of the profession in India, prior to 1949, when it was controlled by the government was judged with reference to certain sets of rules and Regulations. This pattern of code of conduct was formulated in 1949 and incorporated in Chartered Accountants Act, 1949 and the schedules thereto, setting out different forms of behaviour which would constitute professional misconduct under the law. The code of professional conduct was adopted to provide guidance and rules to all members. Those in public practice, industry, government, and education in the performances of their professional responsibilities. The reason for a code of conduct is to encourage members to exercise self-discipline above and beyond laws and regulations. It may be noted here that to fulfil the expectations of the various sections of our economy served by the profession, the code of conduct needs through review. Consistent with the objects of professional ethics to maintain credibility, professionalism, quality of services and confidence.

8.5 Professional Misconduct

Section 22 of the Charterd Accountants Act 1949 defines professional misconduct as deemed to be including any act or omission specified in any of the schedules to the Act.

The Act specifies a number of acts or omission in various schedules which may be construed as professional misconduct.

8.6 Professional Negligence

It is an act of commission or omission which occurs becuase the person concerned has failed to exercise the degree of professional care and skill which is expected of him under the circumstances of the case.

8.7 Difference between Professional Misconduct and Professional Negligence

Professional misconduct denotes situation arising from the violation of rules and regulation as laid down in the Chartered Accountants Act 1949.

Professional negligence on the other hand implies failure to perform duty or duties resulting in damage or loss to the clients.

8.8 The Chartered Accountants Act, 1949 and Professional Misconduct

Diagramatic representation of the Act as regards Professional Misconduct

C.A. Act

- First Schedule
  - Part -I
    - Member in Practice
  - Part-II
    - Member in Service
  - Part-III
    - All Members
- Second Schedule
  - Part-I
    - Member in Practice
  - part-II
    - All Members

A. Part I of First Schedule

It contains thirteen clauses which specify certain circumestances in which a chartered accountant in practice is deemed to be guilty or professional misconduct.

Clause 1. If he allows any person to practise in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by himself.

Clause 2. If he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner.

Clause 3. If he accepts or agrees to accept any part of the profits of the professional work of a lawyer, auctioneer, broker or other agent who is not a member of the Institute.

Clause 4. If he enters into partnership with any person other than a chartered accountant in practice or a person resident without India who but for his residence abroad would be entitled to be registerered as a member under clause (v) of sub-section 1 or section 4 or whose qualification are recognised by the central government or the council for the purpose of permitting such partnerships, provided that the chartered accountant shares in the fees or profits of the business of the partnership both within and without India.

Clause 5. If he secures, either through the services of a person not qualified to be his partner or by means which are not open to a chartered accountant, any professional business.

Clause 6. If he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Clasue 7. If he advertises his professional attainments or services, or uses any designation or expressions other than chartered accountant on professional documents, visiting cards, letter heads or sign-board, unless it be a degree of a university established by law in India or recognised by the central government or a title indicating membership of the Institute of Charterd Accountants or of any other institution that has been recognised by the central government or may be recognised by the council.

Clause 8. If he accepts a position as auditor previously held by another Chartered Accountant or a Restricted State Auditor without first communicating with him in writing.

Clause 9. If he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of section 225 of the Companies Act, 1956, in respect of such appointment have been only complied with.

Clasue 10. If he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings or results of such employment, except in cases which are permitted under any regulations made under this Act.

Clause 11. If he engages in any business or occupation other than the profession of chartered accountants unless permitted by the council so to engage. Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company, unless he or any of his partners in interested in such company as an auditor.

Clause 12. If he accepts a position as auditor previously held by some other chartered accountant of a Restricted State Auditor in such conditions as to constitute undercutting.

Clause 13. If he allows a person not being a member of the Institute or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

B. **Part II of First Schedule**

It contains three clauses which specify certain circumstances in which a member of the Institute, being an employee of any company, firm or person, shall be deemed to be guilty of professional misconduct.

Clause 1. If he pays or allows or agree to pay directly or indirectly to any person any share in the emoluments of employment undertaken by him.

Clause 2. If he accepts or agrees to accept any part of fees, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm, person or agent or customer of such company, firm or person by way of commission or gratification.

Clause 3. If he discloses confidential information acquired in the course of his employment except as and when required by law or except as permitted by the employer.

C. **Part III of First Schedule**

As per Part III of the First Schedule to the Chartered Accountants Act, any chartered accountant (whether in practice or not) would by guilty of professional misconduct :

1. If he includes in any statement, return or form to be submitted to the council any particulars knowing them to be false.
2. If he, not being a Fellow, styles himself as a fellow
3. If he does not supply the information called for, or does not comply with the requirements asked for, by the council or any of its committees.

D. **Part I of Second Schedule**

A chartered accountant in practice shall be deemed to be guilty of professional misconduct in any of the ten situations mentioned below.

Clause 1. If he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being inforce.

Clause 2. If he certifies or submits in his name or in the name of his firm a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee of his firm or by another chartered accountant in practice.

Clause 3. If he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast.

Clause 4. If he expresses his opinion on financial statements of any business or any enterprise in which he, his firm or a partner in his firm has a substantial interest, unless he discloses the interest also in his report.

Clause 5. If he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading.

Clause 6. If he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

Clause 7. If he is grossly negligent in the conduct of his professional duties.

Clause 8. If he fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficiently material to negate the expression of an opinion.

Clause 9. If he fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

Clause 10. If he fails to keep moneys of his client in a separte banking account or to use such moneys for purpose of which they are intended.

E. **Part II of Second Schedule**

It contains two rules of misconduct which are applicable to all chartered accoutants, whether in practice or not.

Clause 1. A member of the Institute, whether in practice or not shall be deemed to be guilty or professional misconduct, if he contravens any of the provisions of this Act or the Regulations made there under.

Clause 2. A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he is guilty of such other act or omission as may be specified by the council in his behalf, by notification in the gazette of India.

8.9 Few illustrative cases of Professional Misconduct

(i) A chartered accountant in practice pays 25 per cent of his professional fees to the widow of his deacesed partner purely on humanitarian grounds.

This amounts to professional misconduct in the absence of a clause in the partnership agreement to this effect.

(ii) A chartered accountant in practice forms a partnership with a member of ICAI who does not hold a certificate of practice.

The chartered accountant is guilty of professional misconduct since a chartered accountant in practice can enter into professional partnership only with another chartered accoutant in practice.

(iii) A chartered accountant in practice does not disclose in the audit report a material departure in the financial statements from a mandatory accounting standard of ICAI.

The chartered accountant is guilty of professional misconduct.

(iv) A chartered accountant in practice accepts the appointment as tax auditor of a company without communicating with the previous auditor.

He is guilty of professional misconduct. The requirement for communication with the previous auditor applies to all audit assignments.

8.10 Quality Control for Audit Work (AAS-17)

The objective of this standard is to prescribe the procedures so that quality of audit conducted by the audit firm is maintained and enhanced. It prescribes :

(a) Policies and procedures of an audit firm regarding audit work generally; and

(b) Procedures regarding the work delegated to assistants on the individual audit.

This standards require that quality control policies and procedure should be implemented at both the level of the audit firm and on individual audits.

8.10.1 Quality control for audit firm

This standard prescribes that audit firm should comply all the auditing standards so that quality of audit is ensured.

Quality control of firm level can be ensured by following the undermentioned policies.

(a) Professional Requirements :

Personnel in the firm are to adhere to the principles of independence, integrity, objectivity, confidentiality and professional behaviour.

(b) Skills and competence :

The firm is to be staffed by personnel who have attained and can maintain the technical standards and professional competence required to enable them to fulfil their responsibility with due care.

(c) Assignment :

Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

(d) Delegation :

There is to be sufficient direction, supervision and review of work at all levels to provide resonable assurance that the work performed meets appropriate standards of quality.

(e) Consultation :

Whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.

(f) Acceptance and returning clients :

An evaluation of prospective clients and a review, on an ongoing basis, of existing clients is to be conducted. In making a decision to accept or retain a client, the firm's independence and ability to surve the client properly are to be considered.

(g) Monitoring :

The continued adequacy and operational effictiveness of quality control policies and procedures is to be monitored.

8.10.2 Quality control of individual audit

Whether the particular audit is being carried as per generally accepted auditing standards (GAAS) the following points should be considered to ensure that particular client's audit quality is as per generally accepted auditing standards–

1. Professional competence of assistant deployed in particular audit.
2. Audit programme or direction to audit assistants for conducting the audit.

3. Continuous supervison by senior audit assistant.

4. Periodical review of audit by the partner.

5. Certain additional audit procedures by the personnel other than personnel deployed in particular audit.

8.11 Emerging Issues

Few emerging significant issues in auditing which are currently in focus or are likely to be so in the year to come are discussed here.

8.11.1 Social Audit

Social audit encompasses an assessment of what an enterprise contributes to the society and what it takes away from it. A good number of efforts are being made to devise techniques that measure the contrubution of an enterprise to the society. At the time of introduction of MAOCARO in 1975 (now CARO '03) it was claimed that "regulatory social audit was being introduced and the main objective of the order was to ensure that the social objective of company by chartered accountants is achieved in greater measure considering the basic fact that under modern condition companies have to subserve public interest rather than private gain of the investors." These developments are the result of growing realisation that enterprises have social responsibilities and that their performance as a whole should be taken into consideration.

Many proposals have been put forward to design an extended accounting system which measure the social performance of an enterprise. Some important elements involving social contribution of an enterprise are discussed below :

Relations with people

Training programmes for handicapped workers, contribution to schools for employees, extra cost incurred on hiring persons from minority or suppressed communities, health-care programmes, spreading of literacy, women empowerment process, eudcation and training for sustainable livelihood etc. would constitute the contribution of the enterprise for improving the relations with people.

Relations with environment

Commitment to sustainable development primarily requires environment protection and its proper conservation. Achieving improvement in eco-efficiently in all operations, setting standard in environment management, actively participating in social welfare and environment development activities for the near by communities etc. constitute the contribution of the enterprise in improving the relations with environment.

Relations with product

In measuring the total performance of an enterprise vis-a-vis the society generally, factors like human resource contribution, public contribution, environmental contributions, product or service contribution and net income of the enterprise are considered.

In absence of any acceptable standards of measuring the total social performance of an enterprise, in India they can use value added statements to show their contribution to national economy.

In India, the report of the social audit committee was released in 1980 by Tata Steel (TISCO). Now-a-days a large number of companies include social reporting in the board of directors report. A paragraph taken from the directors report relating to social report is reproduced below in respect of Indian Alluminium Company Ltd.

"Beyond business..."

"For us in the Aditya Birla Group success is measured by how well we fulfil our economic, environmental and social responsibility. This "triple-bottom-line" accountability lies at the heart of our group, factoring as it does holistically the interest of all of our shareholders—shareholders, customers, employeers and community at large."

8.11.2 Environmental Audit

Environment accounting and auditing have gained special importance to recent years because protection of environment has become the prime corporate responsibility in achieving the aim of sustainable development.

Environmental audit is defined as a systematic process of obtaining and objectively evaluating the evidence relating to performance of an organisation as reflected in environmental statements. It attempts to examine and report on verifiable quantitative or qualitative information in the areas of environment concerns.

A growing number of companies are now valuntarily disclosing environmental information, both as stand-alone corporate reports and as special environmental or sustainability sections within corporate annual reports. Environmental accounting measures and discloses the impact of activities of an organisation on the environment. It is viewed by the corporates that meeting the needs of today should be fulfilled without compromising the welfare of the future generations. These has been tremendous intrinsic linkage between economic growth and environment protection.

An environment audit normally requires a multi-disciplinary audit team as this audit involves specialised skills which a single individual is not likely to process.

In India, as per Environment (Protection) Act. each organisation which requires consent under the Act relating to environment should submit an environmental audit report for the financial year ending 31 March to the concerned State Pollution Conrol Board by May 15 each year. This report although not compulsory to be audited, contains the following information :

a) Water and raw material consumption

b) Water and pollution generated (Specifying the variation with the standards)

c) Quantities and characteristics of hazardous and solid wastes

d) Impact of pollution control measure on conservation of natural resources on and cost of production and

e) Additional investment proposals for environmental protection.

Keeping in view the serious implications of the adverse impact of the activities of an organisation on environment a large number of enterprises have started conducting audit of environmental performance and legal compliance by the internal auditor or environment auditor and publsih environment policy statment each year with their annual reports.

8.11.3 Peer Review

In view of improving and monitoring the quality of auditing in India the Institute of Chartered Accountants of India has introduced the concept of peer review.

Peer review is a system by which the quality of attestation work of an auditor is examined by another professional of similar standing (Peer). The reviewer examines whether the auditor under review, in performing his professional assignments, have complied with technical standard and implemented proper quality control systems and procedure including documentation.

The ultimate odjective of the peer review is to maintain and enhance the quality of professional work.

8.12 Questions

1. What do you mean by professional ethics and state its relevance in the context of accountancy and auditing profession.
2. Discuss the basic principles by which a professional accountant should be governed in the conduct of his professional relations with others.
3. What is difference between professional misconduct and professional negligence ?
4. Explain the concept of code of conduct.
5. Explain the provisons contained in Part-I of both First and Second schedule to the Chartered Accountants. Act 1949 in respect of professional misconduct for the chartered accountants in practice.
6. Write short notes on the following.

a) Quality control of audit.
b) Social audit.
c) Environment audit
d) Peer review.

8.13 Suggested Readings

1. Contemporary Auditing (6th Edition)–Kamal Gupta, Tata McGraw Hill
2. Auditing Today (6th Edition)–Emile Woolf, Prentice Hall
3. An Insight into Auditing–A Multidimensional Approach, By Dr. B. K. Basu, Basusree Book Stall, Kolkata-73

4. A Handbook of Practical Auditing
–B. N. Tandon
–S. Sudharsanam
–S. Sundharabahu
S. Chand & Company Ltd., New Delhi
5. Students Guide to Auditing Standards
By D. S. Rowat, Taxman
6. Students' Guide to Accounting Standards
By D. S. Rowat, Taxman
7. Accounting Standards and Corporate Accounting Practice, T. P. Ghosh, Taxman
8. Indian Accounting Standards., A Bhattacharya TATA McGrawall.