

PAPER – 6: AUDITING AND ASSURANCE

PART – I : ACADEMIC UPDATE

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

Chapter 5- Fraud and Responsibilities of the Auditor in this Regard

Chapter 10- Company Audit

CHAPTER

5

**FRAUD AND RESPONSIBILITIES OF THE
AUDITOR IN THIS REGARD**



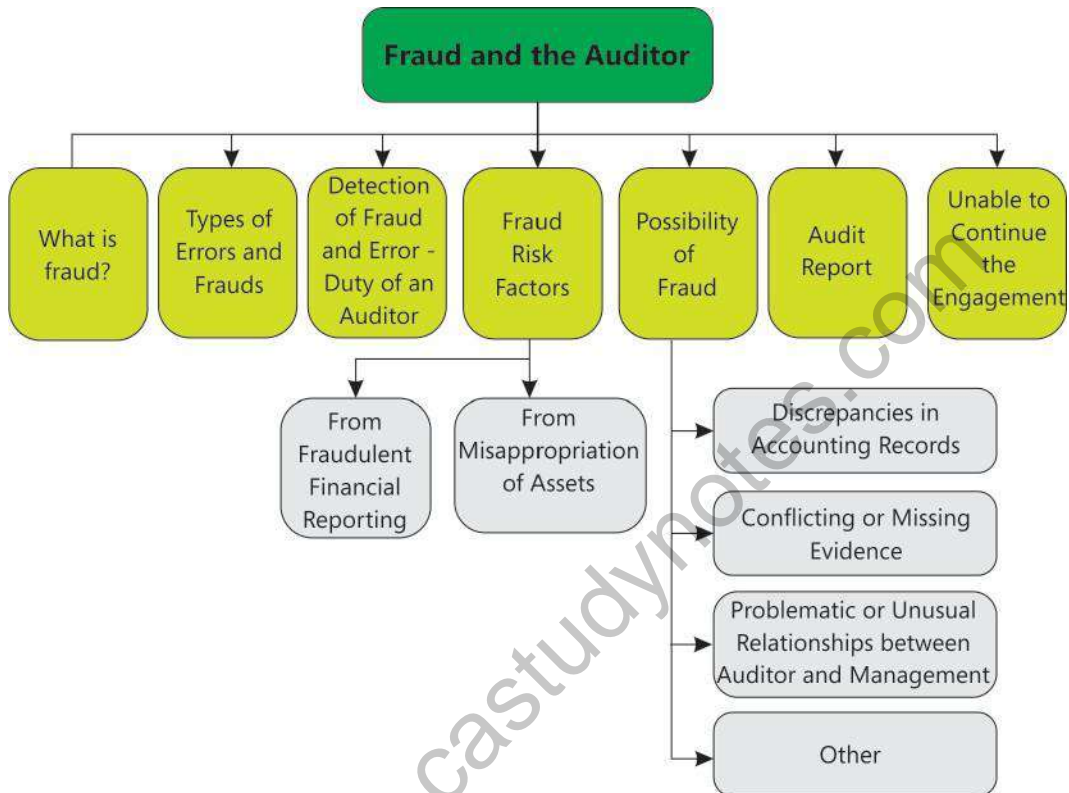
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the types of errors and frauds.
- Definition of fraud as given under the Standards on Auditing and its meaning.
- Understand reasons behind management/ employees committing fraud/ error.
- Analyse the duty of an auditor regarding detection of fraud and error.
- Determine fraud risk factors and circumstances relating to possibility of fraud.
- Understand responsibility of an auditor in case of withdrawal from the engagement if encounter any circumstances that bring into question his ability to continue due to fraud.

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CHAPTER OVERVIEW 



 **1. MEANING OF FRAUD**

The Standard on Auditing (SA) 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” defines the term ‘fraud’ as-

“an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage”.

Although fraud is a broad legal concept, for the purposes of the SAs, **the auditor is concerned with fraud that causes a material misstatement in the financial statements.**

Two types of intentional misstatements are relevant to the auditor–

- ◆ misstatements resulting from fraudulent financial reporting and

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- ◆ misstatements resulting from misappropriation of assets.

Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

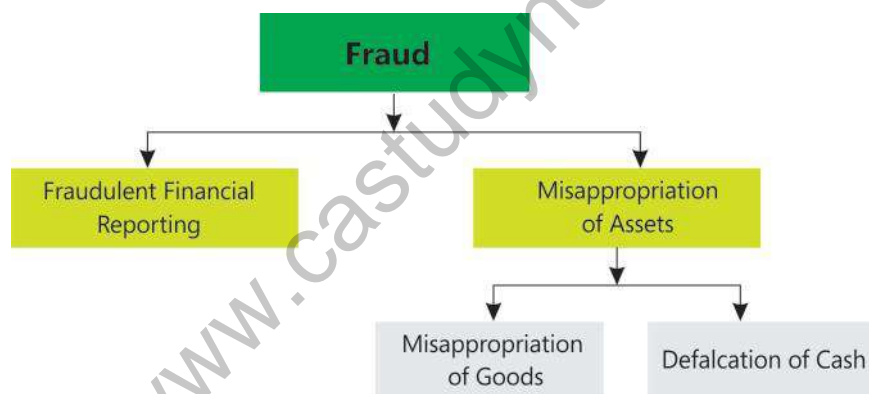
2. CHARACTERISTICS OF FRAUD

2.1 Fraud is Intentional

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

2.2 Fraud is a broad legal concept

The auditor is concerned with fraud that causes a material misstatement in the financial statements.



Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- ◆ Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome.
- ◆ A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the

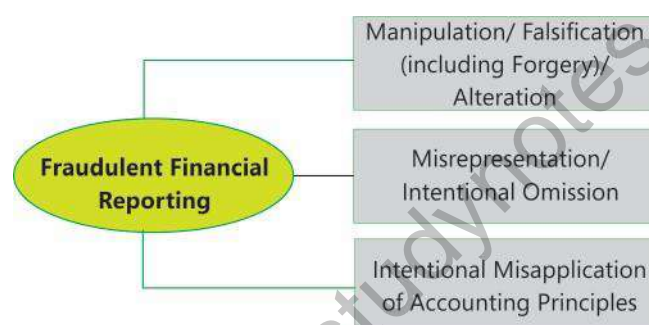
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individual is in a position of trust or has knowledge of specific deficiencies in internal control.

- ◆ Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise, honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

2.2.1 Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users.

Fraudulent financial reporting may be accomplished by the following:



Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.

Manipulation of Accounts: Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:

- to avoid incidence of income-tax or other taxes;
- for declaring a dividend when there are insufficient profits;
- to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and

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- (d) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

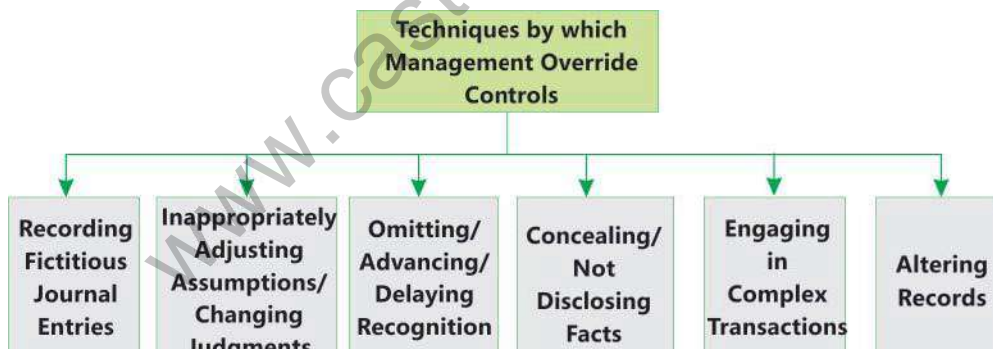
There are numerous ways of committing this type of fraud. Some of the methods are given below:

- (i) inflating or suppressing purchases and expenses;
- (ii) inflating or suppressing sales and other items of income,
- (iii) inflating or deflating the value of closing inventory;
- (iv) failing to adjust outstanding liabilities or prepaid expenses; and
- (v) charging items of capital expenditure to revenue or by capitalising revenue expenses.

Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.

Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:



- ◆ Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- ◆ Inappropriately adjusting assumptions and changing judgments used to estimate account balances.

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- ◆ Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- ◆ Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- ◆ Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- ◆ Altering records and terms related to significant and unusual transactions.

Why do Management/ Employees commit fraud? What induces Management/ Employees to commit fraud? Following are certain instances which will help to understand these questions:



- ◆ Financial obligations/ Pressure.
- ◆ Management's unrealistic goals.
- ◆ Dissatisfied Employees or Lack of motivation among employees.
- ◆ Name game (eg. management using power of authority by asking employees to do something illegal).
- ◆ Opportunity to commit fraud.

2.2.2 Misappropriation of Assets:

It involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:



Fig.: Theft of Assets

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

Example

Vineet is a manager in Zed Ex Ltd. He is having authority to sign cheques up to ₹ 10,000. While performing the audit, Rajan, the auditor, noticed that there were many cheques of ₹ 9,999 which had been signed by Vineet. Further Vineet had split large payments (amounting to more than ₹ 10,000 each, into two or more cheques less than ₹ 10,000 each so that he may authorize the payments). This raised suspicion in the auditor's mind.

The auditor found that the cheques of ₹ 9,999 were deposited in Vineet's personal account i.e. Vineet had misappropriated the amount.

Splitting the cheques into lower amounts involves manipulation of accounts.

The fraud was committed by an employee.

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Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.¹

2.2.2.1 Misappropriation of Goods

Fraud in the form of misappropriation of goods is still more difficult to detect; for this, management has to rely on various measures. Apart from the various requirements of record keeping about the physical quantities and their periodic checks, there must be rules and procedures for allowing persons inside the area where goods are kept. In addition there should be external security arrangements to see that no goods are taken out without proper authority. Goods can be anything in the premises; it may be machinery. It may even be the daily necessities of the office like stationery. The goods may be removed by subordinate employees or even by persons quite higher up in the management. Auditors can detect this by undertaking a thorough and strenuous checking of records followed by physical verification process. Also, by resorting to intelligent ratio analysis, auditors may be able to form an idea whether such fraud exists.

Therefore, it is clear from the above that the 'fraud' deals with intentional misrepresentation but, 'error', on the other hand, refers to unintentional mistakes in financial information.

Intentional errors are most difficult to detect and auditors generally devote greater attention to this type because out of long and sometimes unfortunate experience, auditors have developed a point of view that, if they direct their procedures of discovering the more difficult intentional errors, they are reasonably certain to locate the more simple and far more common unintentional errors on the way.



Fig.: Theft of Goods*

*Source of image: www.clipartster.com

2.2.2.2 Defalcation of Cash

Defalcation of cash has been found to perpetrate generally in the following



ways:

(a) By inflating cash payments:

Examples of inflation of payments:

- (1) Making payments against fictitious vouchers.
- (2) Making payments against vouchers, the amounts whereof have been inflated.
- (3) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.
- (4) Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

(b) By suppressing cash receipts:

Few techniques of how receipts are suppressed are:

- (1) **Teeming and Lading:** Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

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- (2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.
- (3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.
- (4) Not accounting for cash sales fully.
- (5) Not accounting for miscellaneous receipts, *e.g.*, sale of scrap, quarters allotted to the employees, etc.
- (6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

(c) **By casting wrong totals in the cashbook.**

3. DETECTION OF FRAUD AND ERROR—DUTY OF AN AUDITOR

As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the



Fig.: Meticulous Analysis by Auditor for detection of Fraud/Error***

oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance.

Broadly, the general principles laid down in the SA may be noted as under:

1. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole

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are free from material misstatement, whether caused by fraud or error. As described in SA200, "**Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing,**" owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

2. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because, fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.
3. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.
4. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

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Case Study 1

While auditing XYZ Ltd., the auditor was told by Mr. Mahesh, the CEO of the company, that he would be responsible for the fraud & errors, if any, occurring in the books of accounts of the company.

Auditor's Responsibilities for Detection of Fraud and Error: As per SA 240 "The Auditor's Responsibilities relating to fraud in an audit of Financial Statements", an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it to those charged with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirms the existence of the fraud.

The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a fraud, the same should be disclosed in the financial statement. If adequate disclosure is not made, there should be a suitable disclosure in his audit report.

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Case Study 2

After the completion of statutory audit of ABC Ltd., a fraud was detected at the office of the auditee. The management of the company alleged that there is a failure on the part of the auditor to detect fraud and that auditor would be responsible for not detecting fraud in the company.

Detection of Fraud after Completion of Statutory Audit: As per SA 240, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. Such a system reduces but does not eliminate the possibility of fraud and error.

An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion.

The subsequent discovery of material misstatement of the financial information resulting from fraud or error existing during the period covered by the auditor's report does not, in itself, indicate that whether the auditor has adhered to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and reliance placed on internal controls, nature and extent of compliance and substantive tests carried out, etc.) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the results of these procedures.

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The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill. Thus, in the instant case, after the completion of the statutory audit, if a fraud has been detected, the same by itself can not mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.



4. FRAUD RISK FACTORS AND POSSIBILITY OF FRAUD

SA 240, further, explains by way of examples, certain risk factors and circumstances relating to possibility of fraud as may be considered by the auditor which are dealt in the following paragraphs.

4.1 Fraud Risk Factors

Fraud Risk Factors may be defined as events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Examples of Fraud Risk Factors: The fraud risk factors identified here are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e.,

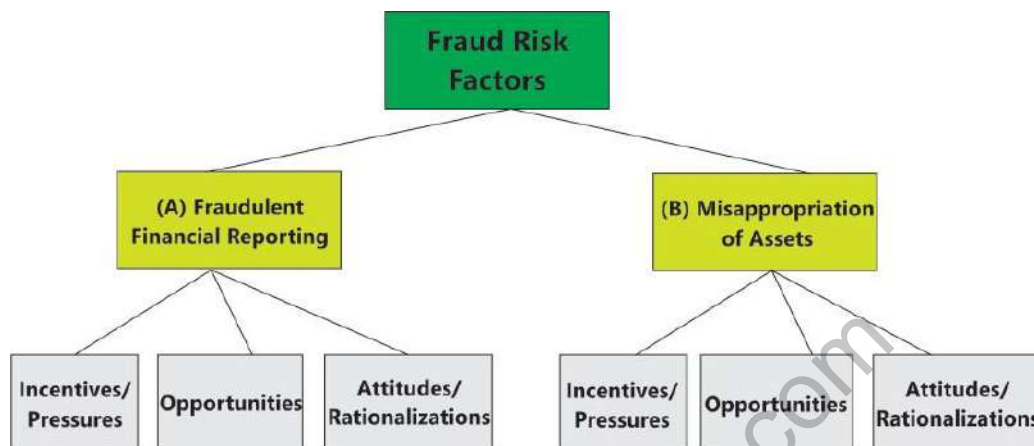
- (A) fraudulent financial reporting, and
- (B) misappropriation of assets.

For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur:

- (a) incentives/pressures,
- (b) opportunities, and

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(c) attitudes/rationalizations.



Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

(A) Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting: The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting-

Incentives/Pressures: Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

1. High degree of competition or market saturation, accompanied by declining margins.
2. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
3. Significant declines in customer demand and increasing business failures in either the industry or overall economy.
4. Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.

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5. Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
6. New accounting, statutory, or regulatory requirements.

Opportunities: The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

1. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
2. A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
3. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
4. Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
5. Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

Attitudes/Rationalizations: Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.

1. Known history of violations of securities laws or other laws and regulations.
2. Excessive interest by management in maintaining or increasing the entity's inventory price or earnings trend.
3. Management failing to remedy known significant deficiencies in internal control on a timely basis.
4. An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.

5. The owner-manager makes no distinction between personal and business transactions.
6. The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
 - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
 - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
 - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

(B) Risk Factors Arising from Misstatements Arising from Misappropriation of Assets: Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/ pressures, opportunities, and attitudes/ rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur.

The following are examples of risk factors related to misstatements arising from misappropriation of assets-

Incentives/Pressures: Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

1. Known or anticipated future employee layoffs.

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2. Recent or anticipated changes to employee compensation or benefit plans.
3. Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities: Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

1. Large amounts of cash on hand or processed.
2. Inventory items that are small in size, of high value, or in high demand.
3. Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
4. Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. **For example, misappropriation of assets may occur because there is the following:**

- ◆ Inadequate segregation of duties or independent checks.
- ◆ Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
- ◆ Inadequate record keeping with respect to assets.
- ◆ Inadequate system of authorization and approval of transactions (for example, in purchasing).
- ◆ Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- ◆ Lack of complete and timely reconciliations of assets.
- ◆ Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- ◆ Lack of mandatory vacations for employees performing key control functions.

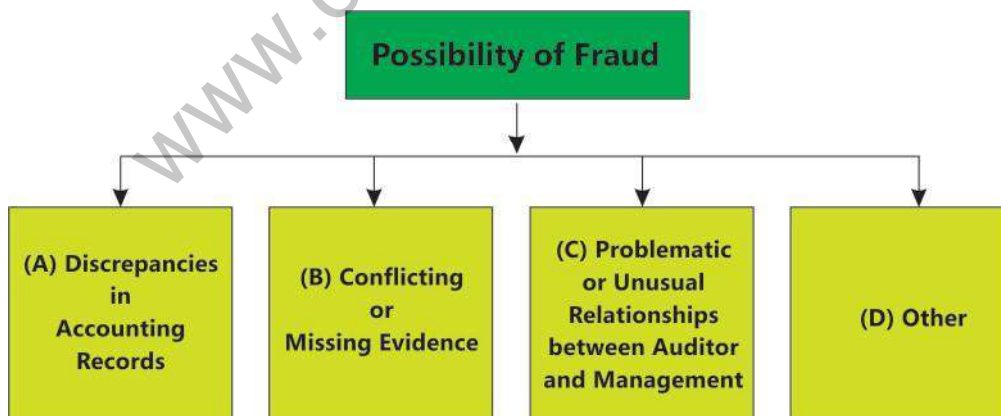
- ◆ Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- ◆ Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations: Disregard for the need for monitoring or reducing risks related to misappropriations of assets.

- ◆ Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- ◆ Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- ◆ Changes in behavior or lifestyle that may indicate assets have been misappropriated
- ◆ Tolerance of petty theft.

4.2 Circumstances Relating to Possibility of Fraud

Examples of circumstances that indicate the possibility of fraud: The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud-



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(A) Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

(B) Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Significant unexplained items on reconciliations.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Missing or non-existent cancelled cheques in circumstances where cancelled cheques are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.

Example

Raj is the auditor of XYZ Ltd. Raj is analysing the financial statements of the company by studying significant ratios. Some of the ratios that he studied were the gross profit ratio and net profit ratio. The gross profit ratio for the current year 2019-20 is 19% and for the previous year 2018-19 was 25%. Similarly, net profit ratio for the current year 2019-20 is 7%, where as in previous year 2018-19 it was 11%.

There is a large variation in the gross profit ratio and net profit ratio over the

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two years. Hence, the auditor has reason to believe that there may be something unusual. He will consider the results of such analytical procedures while drawing up his audit plan and allot more time to studying purchases.

Example

Analytical procedures exhibiting unusual ratios and trend e.g. unusually large trans- actions reported in the last month of the reporting period.

(C) Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
- Undue time pressures imposed by management to resolve complex or contentious issues.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An un willingness to address identified deficiencies in internal control on a timely basis.

(D) Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's Code of Conduct.

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5. FRAUD REPORTING

Reporting to the Central Government: As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the said rule states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ **1 crore or above**, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

- (a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;
- (b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;
- (c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

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- (d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;
- (e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
- (f) the report shall be in the form of a statement as specified in Form ADT-4.

II. Reporting to the Audit Committee or Board: Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub-rule (1) [**i.e. less than ₹ 1 crore**], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

- (a) Nature of Fraud with description;
- (b) Approximate amount involved; and
- (c) Parties involved.

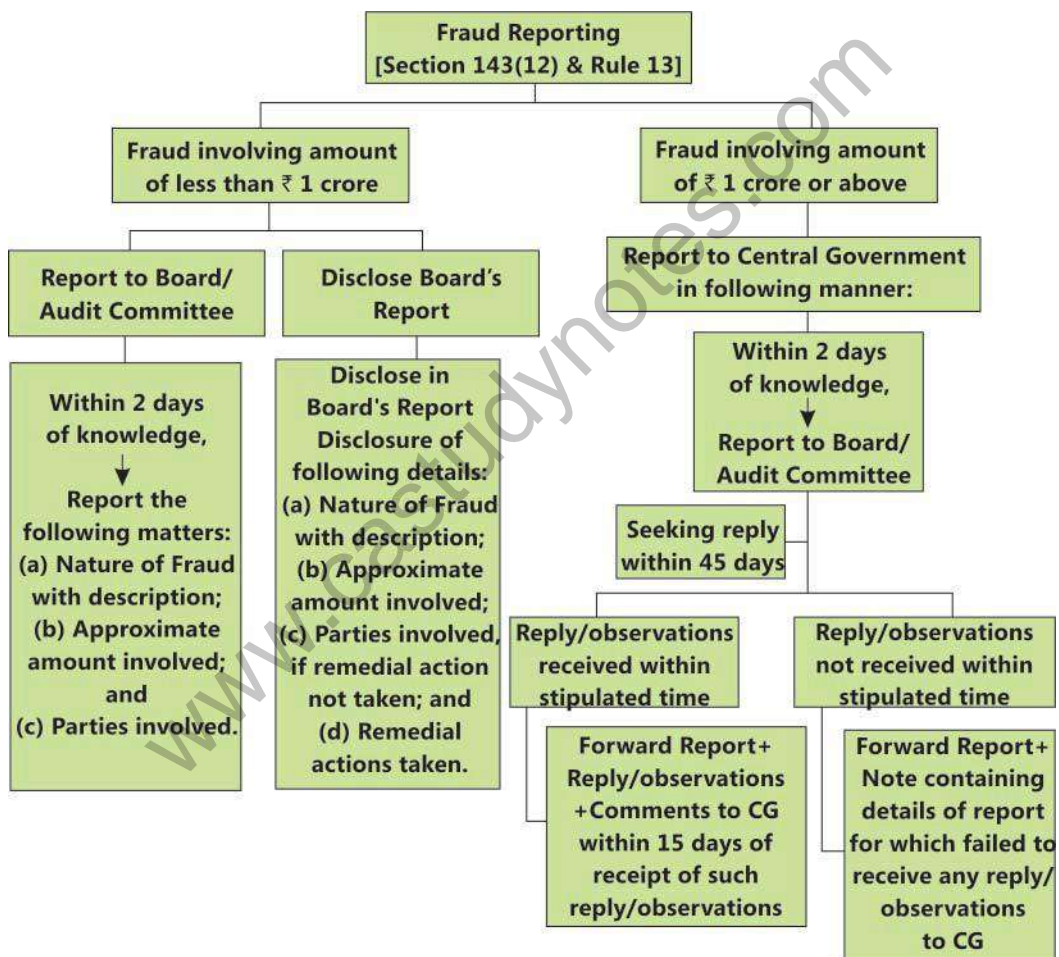
III Disclosure in the Board's Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the auditor is also required to disclose in the Board's

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Report the following details of each of the fraud reported to the Audit Committee or the Board under sub- rule (3) during the year:

- Nature of Fraud with description;
- Approximate Amount involved;
- Parties involved, if remedial action not taken; and
- Remedial actions taken.



Sub-section (13) of section 143 of the Companies Act, 2013 safeguards the act of fraud reporting by the auditor if it is done in good faith. It states that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in

good faith.

It is very important to note that these provisions shall also apply, ***mutatis mutandis***, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12) of section 143, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

Reporting on Frauds already detected and reported: The auditor should apply professional skepticism to evaluate/verify that the fraud was indeed identified/detected in all aspects by the management or through the company's vigil/whistle blower mechanism so that distinction can be clearly made with respect to frauds identified/detected due to matters raised by the auditor vis-à-vis those identified/detected by the company through its internal control mechanism.

Since reporting on fraud under section 143(12) is required even by the cost auditor and the secretarial auditor of the company, it is possible that a suspected offence involving fraud may have been reported by them even before the auditor became aware of the fraud. Here too, if a suspected offence of fraud has already been reported under section 143(12) by such other person, and the auditor becomes aware of such suspected offence involving fraud, he need not report the same since he has not per se identified the suspected offence of fraud.

However, in case of a fraud which involves or is expected to involve individually, an amount of ₹ 1 crore or more, the auditor should review the steps taken by the management/those charged with governance with respect to the reported instance of suspected offence of fraud stated above, and if he is not satisfied with such steps, he should state the reasons for his dissatisfaction in writing and request the management/ those charged with governance to perform additional procedures to enable the auditor to satisfy himself that the matter has been appropriately addressed. If the management/those charged with governance fail to undertake appropriate additional procedures within 45 days of his request, the auditor would need to evaluate if he should report the matter to the Central Government in accordance with Rule 13 of the Companies (Audit and Auditors) Rules, 2014.

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Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]:

The auditor is also required to report under clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of SA 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements".

Audit Procedures and Reporting under CARO:

- (1) While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.
- (2) The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon.

The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

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- (3) The auditor should obtain written representations from management that:
- (i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;
 - (ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;
 - (iii) it has
 - (a) disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and
 - (b) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
4. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items constitute misstatements because [description of reasons]."

The auditor should consider if any fraud has been reported by them during the year under section 143(12) of the Act and if so whether that same would be reported under this Clause. It may be mentioned here that section 143(12) of the Act requires the auditor to have reasons to believe that a fraud is being committed or has been committed by an employee or officer. In such a case the, auditor needs to report to the Central

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Government or the Audit Committee. However, this Clause will include only the reported frauds and not suspected fraud.

5. Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:
 - (i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.
 - (ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.
 - (iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.



6. AUDITOR UNABLE TO CONTINUE THE ENGAGEMENT

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and
- (c) If the auditor withdraws:
 - (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

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- (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

SUMMARY

SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" defines the term 'fraud' as "an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage".

Two types of intentional misstatements are relevant to the auditor-misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. Misappropriation of Assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts.

As per SA 240 the primary responsibility for the prevention and detection of fraud rests with management. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

Fraud Risk Factors may be defined as events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Fraud Reporting [Section 143(12) of Companies Act, 2013 & Rule 13 of CAAR, 2014]

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A. Reporting of Fraud involving amount of less than 1 crore rupees: Auditor to Report Board/Audit Committee within 2 days of knowledge of fraud.

The auditor should Report the following matters:

(a) Nature of Fraud with description; (b) Approximate amount involved; and (c) Parties involved.

Company is bound to disclose certain specified details in Board's Report as (a) Nature of Fraud with description; (b) Approximate amount involved; (c) Parties involved, if remedial action not taken; and (d) Remedial actions taken.

B. Reporting of Fraud involving amount of rupees 1 crore or above: The auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;

- ◆ In case reply/observations received within stipulated time, the auditor is required to forward report along with reply/observations and comments to Central Government within 15 days of receipt of such reply/observations.
- ◆ In case reply/observations not received within stipulated time (within 45 days) the auditor should forward the report along with note containing details of report for which failed to receive any reply/observations to Central Government.

TEST YOUR KNOWLEDGE

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

- (i) Teeming and lading is one of the techniques of inflating cash payments.
- (ii) Fraud can be termed as intentional error.
- (iii) Auditor needs to report to Central Government in case of fraud involving 20 lakhs rupees.
- (iv) The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.

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- (v) Fraudulent financial reporting only involves manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared.
- (vi) Unusual delays by the entity in providing requested information shows **problematic or unusual relationships between the auditor and management.**
- (vii) In comparing management fraud with employee fraud, the auditor's risk of failing to discover the fraud is less for management fraud.
- (viii) Excessive interest by management in maintaining or increasing the entity's inventory price or earnings trend is an example of Fraud Risk Factor related to Opportunities.
- (ix) Misstatements in the financial statements can arise from fraud only.
- (x) Misappropriation of Assets involves the theft of an entity's assets and is often perpetrated by employees in relatively large and material amounts.
- (xi) An auditor conducting an audit in accordance with SAs is responsible for obtaining absolute assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

Theoretical Questions

1. What do you understand by the term 'fraud'? Provide its meaning as given as under the Standard on Auditing (SA) 240.
2. Briefly explain self-revealing errors with the help of some illustration.
3. There are many ways for cash defalcation, one of which is suppressing cash receipts. List out few techniques of how the receipts are suppressed.
4. Fraud Risk Factors are the events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. Further, the nature of the industry or the entity's operations also provides opportunities to engage in fraudulent financial reporting. List out some of the cases from where these opportunities may arise.
5. You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. As a statutory Auditor, how would you deal?

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6. Explain the scope of a Company Auditor's enquiry on Fraud matters as enshrined in the Companies (Auditor's Report) Order, 2016.
7. During the Statutory Audit of a Public Limited Company , XYZ Ltd. its auditor, Mr. Bajaj , the engagement partner of Bajaj Chopra & Associates , encounters some exceptional circumstances that bring into question his ability to continue performing the audit while suspecting a fraud arising from material misstatements. Explain the steps to be taken in such a case.
8. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. Enlist some examples of such circumstances.
9. In an audit of Financial statements of PQR Ltd., CA Vikas Khemka finds that the Cash receipts have been suppressed. Give examples of such techniques which may have led him suspect this.
10. Enlist the instances which induce Management/Employees to commit fraud?
11. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Explain some techniques by which fraud can be committed by management overriding controls.

ANSWERS/SOLUTIONS

Answers to Correct/Incorrect

- (i) **Incorrect:** Teeming and Lading is one of the techniques of suppressing cash receipts and not of inflating cash payments. Money received from one customer is misappropriated and the account is adjusted with the subsequent receipt from another customer and so on.
- (ii) **Correct:** Fraud is the word used to mean intentional error. This is done deliberately which implies that there is intent to deceive, to mislead or at least to conceal the truth. It follows that other things being equal they are more serious than unintentional errors because of the implication of dishonestly which accompanies them.
- (iii) **Incorrect:** As per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor,

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has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is ₹ 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than 1 crore) within such time and in such manner as may be prescribed.

Thus, fraud involving amount of 20 lakh rupees should be reported to Audit Committee.

- (iv) **Correct:** As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements'. It is important that management, with the oversight of those charged with governance place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detention and punishment. This involves a commitment to create a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance.
- (v) **Incorrect:** As per SA 240, "The Auditor's Responsibilities Relating to fraud in an Audit of Financial Statements', fraudulent financial reporting may involve manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared, misrepresentation in or intentional omission from, financial statements of events, transaction or other significant information or intentional misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure.
- (vi) **Correct:** It is a strong example of circumstances that indicate the possibility of fraud. This happens only because of the Management's intolerance towards the auditor's Professional skepticism
- (vii) **Incorrect:** In comparing management fraud with employee fraud, the auditor's risk of failing to discover the fraud is greater for management fraud because of management's ability to override existing internal controls
- (viii) **Incorrect:** Excessive interest by management in maintaining or increasing the entity's inventory price or earnings trend is an example of Fraud Risk Factor related to Rationalization.

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- (ix) **Incorrect:** Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
- (x) **Incorrect:-** Misappropriation of Assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts.
- (xi) **Incorrect:-** An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. As described in SA200, "**Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing,**" owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

Answer to Theoretical Questions

1. **Meaning of Fraud:** The SA 240 'The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements; defines the term fraud as an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
2. **Self Revealing Errors:** These are such errors the existence of which becomes apparent in the process of compilation of account. A few illustrations of such errors are given hereunder, showing how they become apparent.

(i)	Omission to post a part of a journal entry to the ledger.	Trial balance is thrown out of agreement
(ii)	Wrong totaling of the Purchase Register	Control Account [e.g. the Sundry Trade payables Account) balances and the aggregate of the balance in the personal ledger will disagree.

(iii)	A failure to record in the cash book amounts paid into or withdrawn from the bank.	Bank reconciliation statement will show up error.
(iv)	A mistake in recording amount received from X in the account of Y.	Statements of account of parties will reveal mistake.

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

3. Declaration of Cash by Supporting Cash Receipts: Refer Para 2.2.2.2
4. Fraud Risk Factors-Opportunities. Refer 4.1
5. Impossible to Continue the Performance of Audit: Refer Para 6.
6. The auditor is also required to report under clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of SA 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements".

7. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

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- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and
- (c) If the auditor withdraws:
- (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.
8. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. **For example, misappropriation of assets may occur because there is the following:**
- Inadequate segregation of duties or independent checks.
 - Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
 - Inadequate record keeping with respect to assets.
 - Inadequate system of authorization and approval of transactions (for example, in purchasing).
 - Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
 - Lack of complete and timely reconciliations of assets.
 - Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
 - Lack of mandatory vacations for employees performing key control functions.

- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
 - Inadequate access controls over automated records, including controls over and review of computer systems event logs.
- 9. (1) *Teeming and Lading:*** Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.
- (2)** Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.
- (3)** Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.
- (4)** Not accounting for cash sales fully.
- (5)** Not accounting for miscellaneous receipts, *e.g.*, sale of scrap, quarters allotted to the employees, etc.
- (6)** Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.
- 10.** Following are such certain instances:-
- Financial obligations/ Pressure.
 - Management's unrealistic goals.
 - Dissatisfied Employees or Lack of motivation among employees.
 - Name game (e.g management using power of authority by asking employees to do something illegal).
 - Opportunity to commit fraud.

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

CHAPTER

10

THE COMPANY AUDIT



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand qualification and disqualification of an auditor.
- Know the procedures of appointment, reappointment, filling up of the casual vacancies and removal of auditor.
- Understand powers and duties of auditor.
- Understand the provisions relating to rotational retirement.

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CHAPTER OVERVIEW



Company Audit

- Appointment of Auditor
- Rotation of Auditor
- Audit Committee
- Auditor's Remuneration
- Removal of Auditor
- Ceiling Limit
- Powers & Duties of Auditor
- Audit Report as per Co., Act 2013
- Joint Audit
- Audit of Branch
- Cost Audit
- Punishment for non-compliance



INTRODUCTION

Companies Act, 2013 is rule based Act. Sections 139 to 148 of the Companies Act, 2013 (hereinafter referred to as the Act unless otherwise mentioned) deal

SECTIONS COVERED IN THIS CHAPTER

139. Appointment of auditors.
140. Removal, resignation of auditor and giving of special notice.
141. Eligibility, qualifications and disqualifications of auditors.
142. Remuneration of auditors.
143. Powers and duties of auditors and auditing standards.
144. Auditor not to render certain services.
145. Auditors to sign audit reports, etc.
146. Auditors to attend general meeting.
147. Punishment for contravention.
148. Central Government to specify audit of items of cost in respect of certain companies.

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with provisions relating to audit of companies. Therefore, it is quite important to understand these provisions very carefully. You may also study sections 128 to 138 relating to "Accounts" of companies for better understanding of the subject. The provisions relating to 'audit' broadly deal with who can be appointed as an auditor under the Act, i.e., qualifications and disqualifications, the manner of appointment and removal of an auditor and rights and duties of an auditor. A scheme of the provisions of the Act relating to audit is given below for quick reference:

1. ELIGIBILITY, QUALIFICATIONS AND DISQUALIFICATIONS OF AN AUDITOR

The provisions relating to eligibility, qualifications and disqualifications of an auditor are governed by **section 141** of the Companies Act, 2013 (hereinafter referred as the Act). The main provisions are stated below:

- (1) A person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.

It may be noted that a firm whereof majority of partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.

- (2) Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

- (3) Under **sub-section (3) of section 141** along with **Rule 10** of the Companies (Audit and Auditors) Rules, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely-

- (a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;



Fig.: Is the person eligible for appointment as auditor?*

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- (b) an officer or employee of the company;
- (c) a person who is a partner, or who is in the employment, of an officer or employee of the company;
- (d) a person who, or his relative or partner -
 - (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company;

It may be noted that the relative may hold security or interest in the company of face value not exceeding Rupees 1,00,000.

It may also be noted that the condition of Rupees 1,00,000 shall, wherever relevant, be also applicable in the case of a company not having share capital or other securities.

Students may also note that in the event of acquiring any security or interest by a relative, above the threshold prescribed, the corrective action to maintain the limits as specified above shall be taken by the auditor **within 60** days of such acquisition or interest.

The following points merit consideration in this regard:

- (a) The value of shares of Rupees 1,00,000 that can be held by relative is the face value not the market value.
- (b) The limit of Rupees 1,00,000 would be applicable where the securities are held by the relative of an auditor and not where the securities are held by an auditor himself or his partner. In case of an auditor or his partner, securities of even small value shall be a disqualification.
- (c) Grace period of 60 days for corrective action shall apply only in respect of securities held by relatives. This would not apply to auditor or his partner.

[The term "**relative**", as defined under the Companies Act, 2013, means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step- father), Mother (including step-mother), Son (including

step- son), Son's wife, Daughter, Daughter's husband, Brother (including step- brother), Sister (including step-sister).]

Example

Ex 1: Mr. A, a practicing Chartered Accountant, is holding securities of XYZ Ltd. having face value of ₹ 900. Whether Mr. A is qualified for appointment as an auditor of XYZ Ltd.?

As per section 141(3)(d)(i), an auditor is disqualified to be appointed as an auditor if he, or his relative or partner holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

In the present case, Mr. A is holding security of ₹ 900 in XYZ Ltd. Therefore, he is not eligible for appointment as an auditor of XYZ Ltd.

Ex 2: Mr. P is a practicing Chartered Accountant and Mr. Q, the relative of Mr. P, is holding securities of ABC Ltd. having face value of ₹ 90,000. Whether Mr. P is qualified from being appointed as an auditor of ABC Ltd.?

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Further, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the present case, Mr. Q. (relative of Mr. P), is having securities of ₹ 90,000 face value in ABC Ltd., which is as per requirement of proviso to section 141(3)(d)(i). Therefore, Mr. P will not be disqualified to be appointed as an auditor of ABC Ltd.

Ex 3: M/s BC & Co. is an Audit Firm having partners Mr. B and Mr. C, and Mr. A the relative of Mr. C, is holding securities of MWF Ltd. having face value of ₹ 1,01,000. Whether M/s BC & Co. is qualified from being appointed as an auditor of MWF Ltd.?

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate

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company or a subsidiary of such holding company. Further as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, M/s BC & Co, will be disqualified for appointment as an auditor of MWF Ltd. as the relative of Mr. C (i.e. partner of M/s BC & Co.) is holding the securities in MWF Ltd. which is exceeding the limit mentioned in proviso to section 141(3)(d)(i).

Ex 4: M/s RM & Co. is an audit firm having partners CA. R and CA. M. The firm has been offered the appointment as an auditor of Enn Ltd. for the Financial Year 2016-17. Mr. Bee, the relative of CA. R, is holding 5,000 shares (face value of ₹ 10 each) in Enn Ltd. having market value of ₹ 1,50,000. Whether M/s RM & Co. is disqualified to be appointed as auditors of Enn Ltd.?

As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹1,00,000.

In the instant case, M/s RM & Co. is an audit firm having partners CA. R and CA.

M. Mr. Bee is a relative of CA. R and he is holding shares of Enn Ltd. of face value of ₹50,000 only (5,000 shares x ₹ 10 per share).

Therefore, M/s RM & Co. is not disqualified for appointment as an auditors of Enn Ltd. as the relative of CA. R (i.e. partner of M/s RM & Co.) is holding the securities in Enn Ltd. which is within the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

- (ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of Rupees 5,00,000; or

- (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the Company or its Subsidiary, or its Holding or Associate Company or a Subsidiary of such Holding Company, in excess of Rupees 1,00,000.
- (e) a person or a firm who, whether directly or indirectly has business relationship with the Company, or its Subsidiary, or its Holding or Associate Company or Subsidiary of such holding company or associate company, of such nature as may be prescribed;

Students may note that for the purpose of clause (e) above, the term "business relationship" shall be construed as any transaction entered into for a commercial purpose, except –

- (i) commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;
 - (ii) commercial transactions which are in the ordinary course of business of the company at arm's length price - like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.
- (f) a person whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel.
 - (g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than Rupees 100 crore.
 - (h) a person who has been convicted by a Court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.

- (i) *a person who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company.*

It may be noted that, for the purposes of this clause, the term "directly or indirectly" shall have the same meaning as assigned to it in the Explanation to section 144, i.e.

In case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual, shall be termed as rendering of services directly or indirectly by the auditor; and

In case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever,

in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners, shall be termed as rendering of services directly or indirectly by the auditor.

Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which



shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:

Fig.: Auditor restrained from entering into certain services*

- (i) accounting and book keeping services;
- (ii) internal audit;
- (iii) design and implementation of any financial information system;
- (iv) actuarial services*;

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- (v) investment advisory services;
- (vi) investment banking services;
- (vii) rendering of outsourced financial services;
- (viii) management services; and
- (ix) any other kind of services as may be prescribed.

*Actuarial services broadly pertain to services relating to evaluation of financial impact of risks using range of mathematical and statistical methods

It may be noted that an auditor or audit firm who or which has been performing any non- audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

Example

CA. Poshin is providing the services of investment banking to C Ltd. Later on, he was also offered to be appointed as an auditor of the company for the current financial year. Advise.

Section 141(3)(i) of the Companies Act, 2013 disqualifies a person for appointment as an auditor of a company who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company. Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor which includes investment banking services.

Therefore, CA. Poshin is advised not to accept the assignment of auditing as the investment banking service is specifically notified in the list of services not to be rendered by him as per section 141(3)(i) read with section 144 of the Companies Act, 2013.

- (4) Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in **sub-section (3)** after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

CASE STUDY

Facts of the Case: Mr. A, a chartered accountant, has been appointed as an auditor of Laxman Ltd. in the Annual General Meeting of the company held in September, 2016, which assignment he accepted. Subsequently in January, 2017 he joined Mr. B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.

Provisions and Explanation: Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) of Section 141, he shall be deemed to have vacated his office as an auditor.

Conclusion: In the present case, Mr. A, an auditor of Laxman Ltd., joined as partner with Mr. B, who is Manager Finance of Laxman Limited. The given situation has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of Laxman Limited in accordance with sub-section (4) of section 141.



2. APPOINTMENT OF AUDITOR

Section 139 of the Companies Act, 2013 contains provisions regarding Appointment of Auditors. Discussion on appointment of auditors may be grouped under two broad headings-

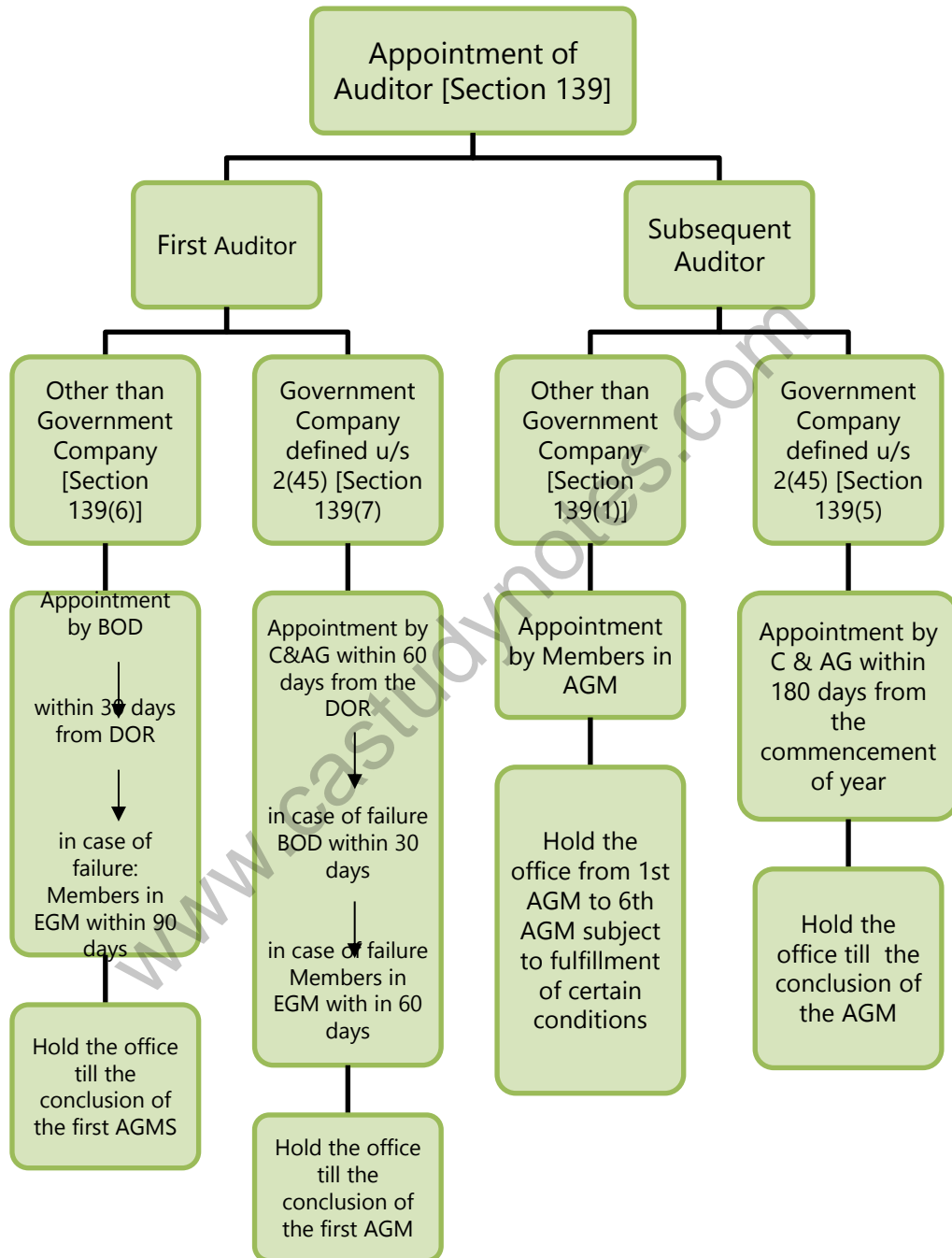
- (I) Appointment of First Auditors.
- (II) Appointment of Subsequent Auditors.



Fig: Meeting for appointment of Auditor*

* Source of image : <http://newhavenscience.org>

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2.1 Appointment of First Auditor

2.1.1 Appointment of First Auditors in the case of a company, other than a Government Company

As per **Section 139(6)**, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

CASE STUDY

Facts of the Case: Managing Director of Pigeon Ltd. himself wants to appoint CA. Champ, a practicing Chartered Accountant, as first auditor of the company.

Provisions and Explanation: Section 139(6) of the Companies Act, 2013 lays down that the first auditor of a company shall be appointed by the Board of Directors within 30 days from the date of registration of the company. In the instant case, the proposed appointment of CA. Champ, a practicing Chartered Accountant, as first auditor by the Managing Director of Pigeon Ltd. by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company.

Conclusion: In view of the above, the Managing Director of Pigeon Ltd. should be advised not to appoint the first auditor of the company.

2.1.2 Appointment of First Auditors in the case of Government Company:

A "Government company" is a company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

Section 139(7) provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central

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Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

CASE STUDY

Facts of the Case: The first auditor of Bhartiya Petrol Ltd., a Government company, was appointed by the Board of Directors.

Provisions and Explanation: In the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013 which states that in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. Hence, in the case of Bhartiya Petrol Ltd., being a government company, the first auditor shall be appointed by the Comptroller and Auditor General of India.

Conclusion: Thus, the appointment of first auditor made by the Board of Directors of Bhartiya Petrol Ltd., is null and void.

2.2 Appointment of Subsequent Auditor/Reappointment of Auditor

2.2.1 Appointment of Subsequent Auditors in case of Non Government Companies:

Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

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The following points need to be noted in this regard-

- (i) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.
- (ii) **Under Rule 4** of The Companies (Audit and Auditors) Rules, 2014, the said certificate shall state the following:-
 - (a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Act, the Chartered Accountants Act, 1949 and the rules or regulations made thereunder;
 - (b) the proposed appointment is as per the term provided under the Act;
 - (c) the proposed appointment is within the limits laid down by or under the authority of the Act;
 - (d) the list of proceedings against the auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.
- (iii) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

2.2.2 Appointment of Subsequent Auditors in case of Government Companies:

As per **section 139(5)**, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

Therefore, it is to be clearly understood that in case of government companies or companies controlled by government, auditor is appointed by Comptroller

and Auditor general of India in the manner provided in Section 139(5) and 139(7). It is to be remembered that Comptroller and auditor general of India is independent constitutional authority which audits all receipts and expenditure of Government of India and state governments including those of bodies, corporations financed by government.

2.3 Filling of a Casual Vacancy

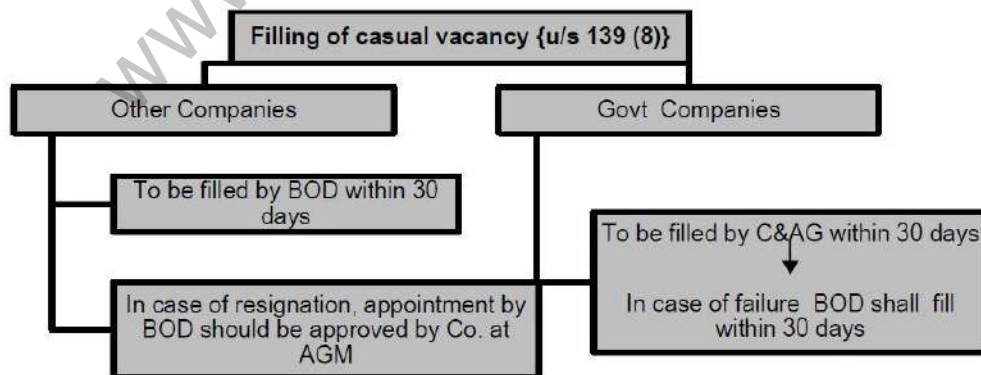
As per **Section 139(8)**, any casual vacancy in the office of an auditor shall-

- (i) **In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

- (ii) **In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next 30 days.



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2.3.1 Casual Vacancy by Resignation:

As per section 140(2) of the Act, the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar.

In case of the companies referred to in section 139(5) i.e. Government company, the auditor shall also file such statement with the CAG along with the company and the Registrar.

The auditor shall indicate the reasons and other facts as may be relevant with regard to his resignation.

In case of failure, the auditor shall be liable to a penalty of fifty thousand rupees or the remuneration of the auditor, whichever is less, and in case of continuing failure, with further penalty of five hundred rupees for each day after the first during which such failure continues, subject to a maximum of five lakh rupees as per section 140(3).

CASE STUDY

Facts of the Case: CA. Donald was appointed as the auditor of PS Ltd. at the remuneration of ₹ 30,000. However, after 4 months of continuing his services, he could not continue to hold his office of the auditor as his wife got a government job at a distant place and he needs to shift along with her to the new place. Thus, he resigned from the company and did not perform his responsibilities relating to filing of statement to the company and the registrar indicating the reasons and other facts as may be relevant with regard to his resignation.

How much fine may he be punishable with under section 140(3) for non-compliance of section 140(2) of the Companies Act, 2013?

Provisions and Explanation: For non-compliance of sub-section (2) of section 140 of the Companies Act, 2013, the auditor shall be punishable with fine, which shall not be less than fifty thousand rupees or the remuneration of the auditor, whichever is less but which may extend to five lakh rupees, under section 140(3) of the said Act.

Conclusion: Thus, the fine under section 140(3) of the Companies Act, 2013 shall not be less than ₹ 30,000 but which may extend to ₹ 5,00,000 .

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Other Important Provisions Regarding Appointment of Auditors

- (1) A retiring auditor may be re-appointed at an annual general meeting, if-
 - (a) he is not disqualified for re-appointment;
 - (b) he has not given the company a notice in writing of his unwillingness to be re - appointed; and
 - (c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.
- (2) Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.



3 ROTATION OF AUDITOR

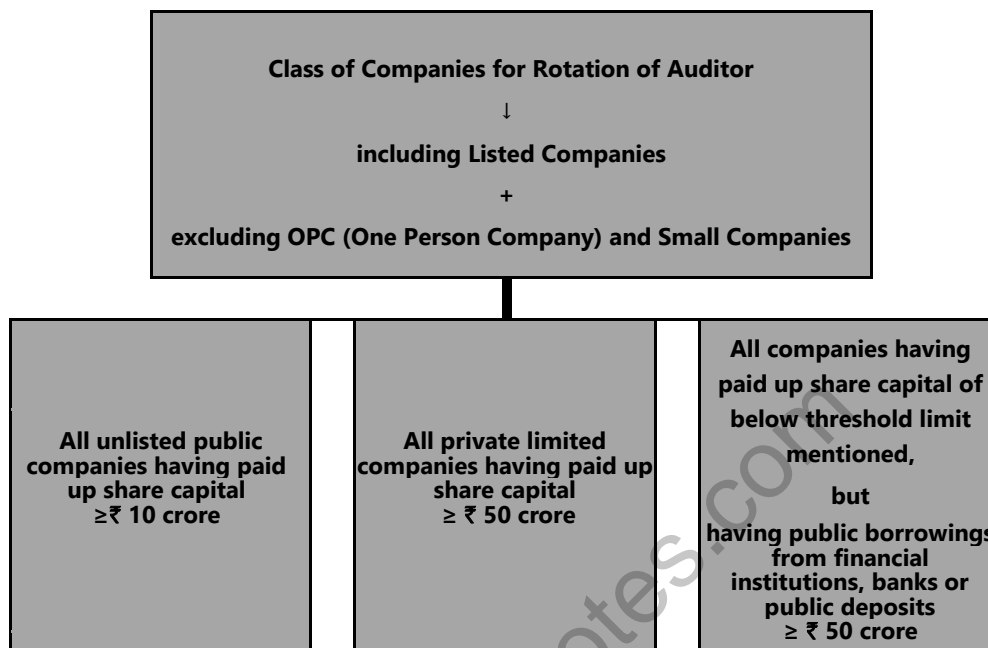
3.1 Applicability of Section 139(2) Rotation of Auditor:

As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the **class of companies** shall mean the following classes of companies excluding one person companies and small companies-



Fig: Rotation of Auditors*

* Source of image: the hindu business line.com



- (i) all unlisted public companies having paid up share capital of rupees ten crore or more;
- (ii) all private limited companies having paid up share capital of rupees fifty crore or more;
- (iii) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

Example

Rano Pvt. Ltd. is a private limited Company, having paid up share capital of ₹ 42 crore but having public borrowing from nationalized banks and financial institutions of ₹ 72 crore, manner of rotation of auditor will be applicable.

As per **section 139(2)**, no listed company or a company belonging to such class or classes of companies as mentioned above, shall appoint or re-appoint-

- (a) an individual as auditor for more than one term of five consecutive years; and
- (b) an audit firm as auditor for more than two terms of five consecutive years. Provided that -

- (i) an individual auditor who has completed his term under clause (a) shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term;
- (ii) an audit firm which has completed its term under clause (b), shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term.

Therefore, provisions of Section 139(2) relating to rotation of auditors are applicable only to listed companies and class of companies satisfying conditions stated in para 3.1 above.

Example

Jolly Ltd., a listed company, appointed M/s Polly & Co., a Chartered Accountant firm, as the statutory auditor in its AGM held at the end of September, 2016 for 11 years. Here, the appointment of M/s Polly & Co. is not valid as the appointment can be made only for one term of five consecutive years and then another one more term of five consecutive years. It can't be appointed for two terms in one AGM only. Further, a cooling period of five years from the completion of term is required i.e. the firm can't be re-appointed for further 5 years after completion of two terms of five consecutive years.

The following points merit consideration in this regard-

- (1) As on the date of appointment, no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years.

Example

M/s XYZ & Co., is an audit firm having partner Mrs. X, Mr. Y and Mr. Z, whose tenure has expired in the company immediately preceding the financial year. M/s ABZ & Co., another audit firm in which Mr. Z is a common partner, will also be disqualified for the same company along with M/S XYZ & Co. for the period of five years.

- (2) Every company, existing on or before the commencement of this Act which is required to comply with provisions of this sub-section, shall comply with the requirements of this sub-section within a period which shall not be later than the date of the first annual general meeting of the

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company held, within the period specified under sub-section (1) of section 96, after three years from the date of commencement of this Act.

Examples

Ex 1: Mr. Raj, a Chartered Accountant, is an individual auditor of Binaca Limited for last 5 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013). Keeping in view the transition period as stated in the Companies Act, 2013, Mr. Raj can continue the audit of Binaca Ltd. upto the first annual general meeting to be held after three years from the date of commencement of the Act.

Ex 2: M/s Raj & Associates, a Chartered Accountants Audit Firm, is doing audit of Binaca Limited for last 11 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013). Keeping in view the transition period as stated in the Companies Act, 2013, M/s Raj Associates can continue the audit of Binaca Ltd. upto the first annual general meeting to be held after three years from the date of commencement of the Act.

Students may interlink the above example with Illustrative table explaining rotation in case of individual auditor as well as audit firm which has been given after the 3.2 i.e. Manner of rotation of Auditors by the Companies on Expiry of their Term.*

- (3) It has also been provided that right of the company to remove an auditor or the right of the auditor to resign from such office of the company shall not be prejudiced.
- (4) Subject to the provisions of this Act, members of a company may resolve to provide that -
 - (a) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or
 - (b) the audit shall be conducted by more than one auditor.
- (5) The Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors.

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3.2 Manner of Rotation of Auditors by the Companies on Expiry of their Term:

Rule 6 of the Companies (Audit and Auditors) Rules, 2014 prescribes the manner of rotation of auditors on expiry of their term which is given below-

- (1) The Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.
- (2) Where a company is required to constitute an Audit Committee, the Board shall consider the recommendation of such committee, and in other cases, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.
- (3) For the purpose of the rotation of auditors-
 - (i) in case of an auditor (whether an individual or audit firm), the period for which the individual or the firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be;
 - (ii) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms.

Explanation I - For the purposes of these rules the term "same network" includes the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

Explanation II - For the purpose of rotation of auditors,

- (a) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;
- (b) if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.

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***Illustration explaining rotation in case of individual auditor**

Number of consecutive years for which an individual auditor has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which he may be appointed in the same company (including transitional period)	Aggregate period which the auditor would complete in the same company in view of column I and II
I	II	III
5 Years (or more than 5 years)	3 years	8 years or more
4 years	3 years	7 years
3 years	3 years	6 years
2 years	3 years	5 years
1 year	4 years	5 years

Note:

- (1) Individual auditor shall include other individuals or firms whose name or trade mark or brand is used by such individual, if any.
- (2) Consecutive years shall mean all the preceding financial years for which the individual auditor has been the auditor until there has been a break by five years or more.

***Illustration explaining rotation in case of audit firm**

Number of consecutive years for which an audit firm has been functioning as auditor in the same company [in the	Maximum number of consecutive years for which the firm may be appointed in	Aggregate period which the firm would complete in the same

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first AGM held after the commencement of provisions of section 139(2)]	the same company (including transitional period)	company in view of column I and II
I	II	III
10 Years (or more than 10years)	3 years	13 years or more
9 years	3 years	12 years
8 years	3 years	11 years
7 years	3 years	10 years
6 year	4 years	10 years
5 years	5 years	10 years
4 years	6 years	10 years
3 year	7 years	10 years
2 years	8 years	10 years
1 years	9 years	10 years

Note:

- (i) Audit Firm shall include other firms whose name or trade mark or brand is used by the firm or any of its partners.
 - (ii) Consecutive years shall mean all the preceding financial years for which the firm has been the auditor until there has been a break by five years or more.
- (4) Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.

As you would have noticed, the provisions relating to disqualifications and rotation of auditors are meant to ensure that audit function remains unbiased. These legal provisions also provide enough safeguards so that auditors can form their opinion in an independent and highly professional manner without any bias.

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4 PROVISIONS RELATING TO AUDIT COMMITTEE

4.1 Applicability of section 177 i.e. Constitution of Audit Committee:

Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

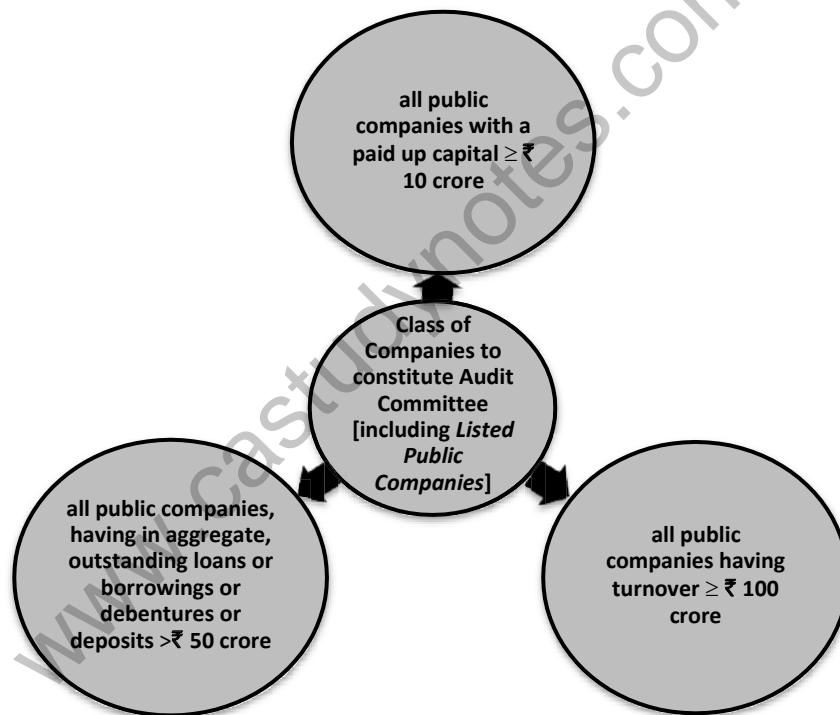


Diagram showing class of companies to constitute Audit Committee

As per provisions of Section 177 of Companies Act, audit committee performs important functions including making recommendation for appointment, remuneration and terms of appointment of auditor of the company, reviewing and monitoring auditor's independence and performance & effectiveness of audit process, examination of financial statements and auditor's report thereon.

It is to be remembered that audit committee consists of directors of the company.

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It consists of minimum 3 directors with independent directors forming majority. Besides, audit committee also performs other important functions. Audit committee helps in ensuring better standards of corporate governance.

It is important to know that in addition to **listed public companies**, following classes of companies shall constitute an Audit Committee -

- (i) all public companies with a paid up capital of ten crore rupees or more;
- (ii) all public companies having turnover of one hundred crore rupees or more;
- (iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

Explanation: The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Therefore, provisions of constitution of audit committee are applicable only to listed companies and public companies satisfying criteria as stated above.

Example

XYZ Ltd., a public company having paid up capital of ₹9 crore but having turnover of ₹ 150 crore, will be required to constitute an Audit Committee under section 177 because the requirement for constitution of Audit Committee arises if the company falls into any of the prescribed category.

4.2 Manner and procedure of selection and appointment of auditors

Rule 3 of CAAR, 2014 prescribes the following manner and procedure of selection and appointment of auditors-

- (1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such

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qualifications and experience are commensurate with the size and requirements of the company.

It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.

- (2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.
- (3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.
- (4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.
- (5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.
- (6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.
- (7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.



5 AUDITOR'S REMUNERATION

As per section 142 of the Act, the remuneration of the auditor of a company

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shall be fixed in its general meeting or in such manner as may be determined therein. However, board may fix remuneration of the first auditor appointed by it.

Further, the remuneration, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company. Therefore, it has been clarified that the remuneration to Auditor shall also include any facility provided to him.

6 REMOVAL OF AUDITORS

6.1 Removal of Auditor Before Expiry of Term



Fig: Auditor leaving office of the auditor*

According to **Section 140(1)**, the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per **Rule 7 of CAAR, 2014-**

- (1) The application to the Central Government for removal of auditor shall be made in **Form ADT-2** and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
- (2) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
- (3) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

Direction by Tribunal in case Auditor acted in a Fraudulent Manner:

As per sub-section (5) of the section 140, the Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, if it

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is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

It may be noted that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

It is hereby clarified that in the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

As you would notice, the provisions of removal of auditor before expiry of his term are also meant to safeguard auditor's independence by imposing strict conditions like prior approval of Central government.

6.2 Appointment of Auditor Other Than Retiring Auditor

Section 140(4) lays down procedure to appoint an auditor other than retiring auditor who was removed-

- (1) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or as the case may be, ten years, as provided under **sub-section (2) of section 139**.
- (2) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.

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- (3) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,-
- (a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and
 - (b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company. and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.

Students may note that if a copy of representation is not sent as aforesaid, a copy thereof shall be filed with the Registrar.

Curtailling right of the auditor regarding circulation of copy of representation in the case of appointment of auditor other than retiring auditor under section 140(4) of the companies act, 2013:

If the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by **section 140(4)** of the Companies Act, 2013 are being abused by the auditor, then, the copy of the representation may not be sent and the representation need not be read out at the meeting.



7. CEILING ON NUMBER OF AUDITS

It has been mentioned earlier that before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in **section 141(3)(g)** of the Companies Act, 2013 which prescribes that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than **twenty companies** other than one person companies, dormant companies, small

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companies and private companies having paid-up share capital less than ₹ 100 crore, shall not be eligible for appointment as an Auditor of a Company.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

CASE STUDY

"ABC & Co." is an Audit Firm having partners "Mr. A", "Mr. B" and "Mr. C", Chartered Accountants. "Mr. A", "Mr. B" and "Mr. C" are holding appointment as an Auditor in 4, 6 and 10 Companies respectively.

- (i) Provide the maximum number of Audits remaining in the name of "ABC & Co."
- (ii) Provide the maximum number of Audits remaining in the name of individual partner i.e. Mr. A, Mr. B and Mr. C.
- (iii) Can ABC & Co. accept the appointment as an auditor in 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company?
- (iv) Would your answer be different, if out of those 60 private companies, 45 companies are having paid-up share capital of ₹ 110 crore each?

Fact of the Case: In the instant case, Mr. A is holding appointment in 4 companies, whereas Mr. B is having appointment in 6 Companies and Mr. C is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

Provisions and Explanations: Section 141(3)(g) of the Companies Act, 2013 states that the following persons shall not be eligible for appointment as an auditor of a company i.e. a person who is in full time employment elsewhere; or a person, or a partner of a firm holding appointment as its auditor, if such person, or partner is at the date of such appointment, or reappointment holding appointment as auditor of

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more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.

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

Conclusion:

- (i) Therefore, ABC & Co. can hold appointment as an auditor of 40 more companies:

Total Number of Audits available to the Firm Number = $20 \times 3 = 60$
of Audits already taken by all the partners

In their individual capacity = $4 + 6 + 10 = 20$

Remaining number of Audits available to the Firm = 40

- (ii) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g)- already holding appointments as an auditor. Hence (1) Mr. A can hold: $20 - 4 = 16$ more audits. (2) Mr. B can hold $20 - 6 = 14$ more audits and (3) Mr. C can hold $20 - 10 = 10$ more audits.

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

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

Therefore, ABC & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than ₹ 100 crore and 40 private companies having

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paid-up share capital of ₹ 110 crore each in addition to above 20 company audits already holding.

Council General Guidelines, 2008 (Chapter VIII): In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India hereby specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 224 and /or Section 226 of the Companies Act, 1956 (now section 141(3)(g) of the Companies Act, 2013).

It may be noted that in the case of a firm of chartered accountants in practice, the specified number of audit assignments shall be construed as the specified number of audit assignments for every partner of the firm.

It may also be noted that where any partner of the firm of chartered accountants in practice is also a partner of any other firm or firms of chartered accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the specified number of audit assignments in the aggregate.

It is further provided that where any partner of a firm or firms of chartered accountants in practice accepts one or more audit assignments in his individual capacity, or in the name of his proprietary firm, the total number of such assignment which may be accepted by all firms in relation to such chartered accountant and by him shall not exceed the specified number of audit assignments in the aggregate.

- (1) In computing the specified number of audit assignments-
 - (a) the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other chartered accountant in practice or firm of such chartered accountants, shall be taken into account.
 - (b) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.
 - (c) a chartered accountant in full time employment elsewhere shall not be taken into account.

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- (2) A chartered accountant in practice as well as firm of chartered accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of chartered accountants, or by any of the partner of the firm in his individual name or as a partner of any other firm as far as possible, in the prescribed manner.

Ceiling on Tax Audit Assignments: The specified number of tax audit assignments that an auditor, as an individual or as a partner of a firm, can accept is **60 numbers**. ICAI has notified that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he accepts in a financial year, more than the specified number of tax audit assignments u/s 44AB.

8. POWERS/RIGHTS OF AUDITORS

The auditor has the following powers/rights while conducting an audit:

(a) Right of access to books, etc. – Section 143(1) of the Act provides that the auditor of a company, at all times, shall have a right of access to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and he is entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor.

It may be noted that according to **section 2(59)** of the Act, the term 'officer' includes any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act;

The phrase 'books, accounts and vouchers' includes all books which have any bearing, or are likely to have any bearing on the accounts, whether these be the usual financial books or the statutory or statistical books; memoranda books, e.g., inventory books, costing records and the like may also be inspected by the auditor. Similarly the term 'voucher' includes all or any of the correspondence which may in any way serve to vouch for the accuracy of the accounts. Thus, the right of access is not restricted to books of account alone and it is for the auditor to determine what record or document is necessary for the purpose of the audit.

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The right of access is not limited to those books and records maintained at the registered or head office so that in the case of a company with branches, the right also extends to the branch records, if the auditor considers it necessary to have access thereto as per **Section 143(8)**.

Example

X Ltd. restrains its company auditor from visiting another branch at different location and having access to the inventory records maintained at that branch because the branch is already audited by another auditor and the report has been received. Here, it may be noted that the company auditor has right to visit the branch, even if the branch accounts are audited by another auditor, if he considers it necessary to do so for the performance of his duties as auditor.

(b) Right to obtain information and explanation from officers - This right of the auditor to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor is a wide and important power. In the absence of such power, the auditor would not be able to obtain details of amount collected by the directors, etc. from any other company, firm or person as well as of any benefits in kind derived by the directors of the company, which may not be known from an examination of the books. It is for the auditor to decide the matters in respect of which information and explanations are required by him. When the auditor is not provided the information required by him or is denied access to books, etc., his only remedy would be to report to the members that he could not obtain all the information and explanations he had required or considered necessary for the performance of his duties as auditors.

(c) Right to receive notices and to attend general meeting – The auditors of a company are entitled to attend any general meeting of the company (the right is not restricted to those at which the accounts audited by them are to be discussed); also to receive all the notices and other communications relating to the general meetings, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

Section 146 of the Companies Act, 2013 discusses right as well as duty of the auditor. According to the section 146:

“all notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his

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authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.”

Thus, it is right of the auditor to receive notices and other communications relating to any general meeting and to be heard at such meeting, relating to the matter of his concern, however, it is duty of the auditor to attend the same or through his authorised representative unless otherwise exempted.

(d) Right to report to the members of the company on the accounts examined by him – The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company’s affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

(e) Right to Lien – In terms of the general principles of law, any person having the lawful possession of somebody else’s property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property. On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non payment of fees, for work done on the books and documents. The Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions:

- (i) Documents retained must belong to the client who owes the money.
- (ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.
- (iii) The auditor can retain the documents only if he has done work on the documents assigned to him.

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- (iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

Under **section 128** of the Act, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. The company provides reasonable facility to auditor for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints. His working papers being his own property, the question of lien, on them does not arise.

SA 230 issued by ICAI on Audit Documentation (explanatory text, A- 25), "Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel."

9. DUTIES OF AUDITORS

Sections 143 of the Companies Act, 2013 specifies the duties of an auditor of a company in a quite comprehensive manner. It is noteworthy that scope of duties of an auditor has generally been extending over all these years.

- (1) **Duty of Auditor to Inquire on certain matters:** Under provisions of section 143(1), it is the duty of auditor to inquire into the following matters-
- (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 prejudicial to the interests of the company or its members;
 - (b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

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- (c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) whether loans and advances made by the company have been shown as deposits;
- (e) whether personal expenses have been charged to revenue account;
- (f) where it is stated in the books and documents 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.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) is reproduced below:

“The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor’s Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that

the auditor has to consider his duties under section 143(1).”

Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

(2) Duty to report:

Under provisions of Section 143(2), the auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit

report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (11).

Further, auditor has to report whether to best of his information and knowledge, the said accounts, financial statements give a true and fair view of ***the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and following matters as prescribed under relevant rules:-***

- (a) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
- (b) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
- (c) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

As per **section 143(3)**, the auditor's report shall also state–

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (e) whether, in his opinion, the financial statements comply with the accounting standards;

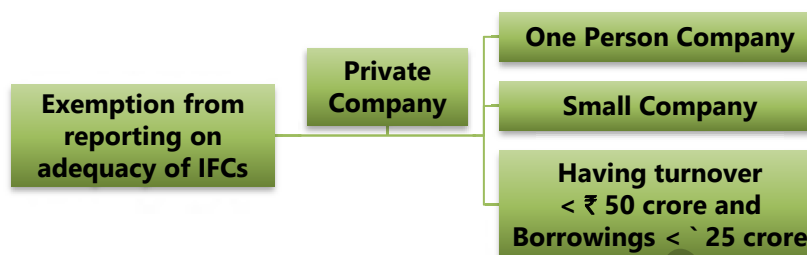
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- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- (g) whether any director is disqualified from being appointed as a director under sub- section (2) of the section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- (i) whether the company has adequate internal financial controls **with reference to financial statements** in place and the operating effectiveness of such controls;

However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a–

- (i) One person company; or**
 - (ii) Small company; or**
 - (iii) Company having turnover less than ₹ 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than ₹ 25 crore.**
- (j) such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-
- (i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
 - (ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

- (iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.



[Notes: (1) Students may note that the auditor is also required to report on certain additional matters specified under CARO, 2016 which is discussed later under Para 10 Reporting under Companies (Auditor's Report) Order, 2016.

(2) Students are also required to refer Guidance note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013.]

Further, in case of government companies and companies controlled by government, the Comptroller and auditor general of India shall direct the auditor of such companies the manner in which accounts of such companies are required to be audited. The copy of such report shall be submitted to the Comptroller and auditor general of India. It is to be further noted that Comptroller and auditor general of India has a right to conduct supplementary audit of financial statements of such companies within 60 days of receipt of audit report.

[Notes: For detailed provisions of CARO, 2016, students may refer Para 10 Reporting under Companies (Auditor's Report) Order, 2016 which is discussed subsequently]

- (3) **Duty to Sign the Audit Report:** As per section 145 of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of section 141(2).

Section 141(2) of the Companies Act, 2013 states that where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

The qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting.

- (4) **Duty to comply with Auditing Standards:** As per **section 143(9)** of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further, as per **section 143(10)** of the Act, the Central Government may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.
- (5) **Duty to report on frauds:**
- A. **Reporting to the Central Government-** As per **section 143(12)** of the Companies Act, 2013 read with **Rule 13** of the Companies (Audit and Auditors) Rules, 2014, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as prescribed.
- B. **Reporting to the Audit Committee or Board-** In case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed.
- C. **Disclosure in the Board's Report:** The companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as prescribed.

Sub-section (13) of section 143 of the Companies Act, 2013 safeguards the act of fraud reporting by the auditor if it is done in good faith. It states that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

It is very important to note that the provisions regarding fraud reporting

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shall also apply, *mutatis mutandis*, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12) of section 143, he shall be punishable with fine which shall not be less than ₹ 1 lakh but which may extend to ₹ 25 lakh.

The auditor is also required to report under **clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016 [CARO, 2016]**, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

[Notes: For detailed provisions of CARO, 2016, students may refer Para 10 Reporting under Companies (Auditor's Report) Order, 2016]

Example: The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of ₹ 50 lakh and cleared all the payments to such bogus creditor. Here, the auditor of the company is required to report the fraudulent activity to the Board or Audit Committee (as the case may be) within 2 days of his knowledge of fraud. Further, the company is also required to disclose the same in Board's Report.

It may be noted that the auditor need not to report the central government as the amount of fraud involved is less than ₹ 1 crore, however, reporting under CARO, 2016 is required.

(6) Duty to report on any other matter specified by Central Government:

The Central Government may, in consultation with the National Financial Reporting Authority (NFRA), by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

However, as per the notification dated 29.03.2016, till the time NFRA is constituted, the Central Government may hold consultation required under this sub-section with the Committee chaired by an officer of the rank of Joint Secretary or equivalent in the MCA and the Committee shall have the representatives from the ICAI and Industry Chambers and also special invitees from the National Advisory Committee on Accounting Standards (NACAS) and the office of the C&AG.

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[Note: Students may note that Companies (Auditor's Report) Order, 2016 has been notified in this perspective which is discussed later under Para 10 Reporting under Companies (Auditor's Report) Order, 2016]

- (7) **Duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor are discussed separately in the chapter under heading 13 branch audit.**
- (8) **Duty to state the reason for qualification or negative report:** As per **section 143(4)**, where any of the matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons there for.



10. REPORTING UNDER COMPANIES (AUDITOR'S REPORT) ORDER, 2016 [CARO, 2016]

The Central Government, after consultation with the committee constituted under proviso to **section 143(11)** of the Companies Act, 2013, and in supersession of the Companies (Auditor's Report) Order, 2015 dated the 10th April, 2015, has issued the Companies (Auditor's Report) Order, 2016, (CARO, 2016) under section 143(11) of the Companies Act, 2013, dated 29th March, 2016. The requirements of the Order are supplemental to the existing provisions of section 143 of the Act regarding the auditor's report.

The Order is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein.

Applicability of the Order: The CARO, 2016 is an additional reporting requirement Order. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013.

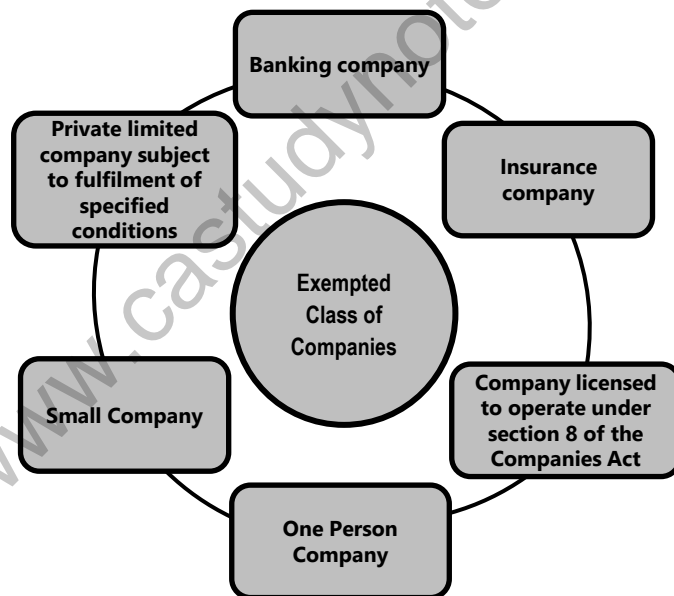
However, the Order specifically **exempts** the following class of companies-

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
- (ii) an insurance company as defined under the Insurance Act, 1938;
- (iii) a company licensed to operate under section 8 of the Companies Act;

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- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act;
- (v) a small company as defined under clause (85) of section 2 of the Companies Act; and
- (vi) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than ₹ 1 crore as on the balance sheet date and which does not have total borrowings exceeding ₹ 1 crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding ₹ 10 crore during the financial year as per the financial statements.

It may be noted that the Order shall not be applicable to the auditor's report on consolidated financial statements.



EXAMPLES

Ex. 1: 'Educating Child' is a limited company registered under section 8 of the Companies Act, 2013.

In the given case, 'Educating Child' is licensed to operate under section 8 of the Companies Act, 2013. Therefore, CARO, 2016 shall not be applicable to 'Educating Child' accordingly.

Ex. 2: *Ashu Pvt. Ltd. has fully paid capital and reserves of ₹ 50 lakh. During the year, the company had borrowed ₹ 70 lakh each from a bank and a financial institution independently. It has the turnover of ₹ 900 lakh.*

In the given case of Ashu Pvt. Ltd., it has paid capital and reserves of ₹ 50 lakh i.e. less than ₹ 1 crore, turnover of ₹ 9 crore i.e. less than ₹ 10 crore. However, it has maximum outstanding borrowings of ₹ 1.40 crore (₹ 70 lakh + ₹ 70 lakh) collectively from bank and financial institution.

Therefore, it fails to fulfill the condition relating to borrowings. Thus, CARO, 2016 shall be applicable to Ashu Pvt. Ltd. accordingly.

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

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
- (b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- (c) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;
- (ii) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;
- (iii) whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,
 - (a) whether the terms and conditions of the grant of such loans are not

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- prejudicial to the company's interest;
- (b) whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
 - (c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
- (iv) in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.
 - (v) in case the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?
 - (vi) where maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.
 - (vii) (a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;
 - (b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A

mere representation to the concerned Department shall not constitute a dispute).

- (viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).
- (ix) whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;
- (x) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;
- (xi) whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act, 2013? If not, state the amount involved and steps taken by the company for securing refund of the same;
- (xii) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
- (xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;
- (xiv) whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of

non-compliance;

- (xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;
- (xvi) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

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

Further, where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons why it is not possible for him to give his opinion on the same.

Example: *The company has dispensed with the practice of taking inventory of their inventories at the year-end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations. Explain reporting requirement under CARO, 2016.*

Reporting for Physical Verification of Inventory: *Clause (ii) of Para 3 of CARO, 2016, requires the auditor to report whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.*

The physical verification of inventory is the responsibility of the management of the company which should verify all material items at least once in a year and more often in appropriate cases.

In the given case, the above requirement of physical verification of inventory by the management has not been taken place and therefore the auditor should point out the same under CARO, 2016. He may consider the impact on financial statement and report accordingly.



11. DISCLOSURE IN THE AUDITOR'S REPORT

The following paragraphs deal with the manner of qualification and the manner of disclosure, if any, to be made in the auditor's report.

AS-1 – Disclosure of Accounting Policies

In the case of a company, members should qualify their audit reports in case –

- (a) accounting policies required to be disclosed under Schedule III or any other provisions of the Companies Act, 2013 have not been disclosed, or
- (b) accounts have not been prepared on accrual basis, or
- (c) the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or
- (d) proper disclosures regarding changes in the accounting policies have not been made.

Where a company has been given a specific exemption regarding any of the matters stated above but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

In view of the above, the auditor will have to consider different circumstances whether the audit report has to be qualified or only disclosures have to be given.

In the case of enterprises not governed by the Companies Act, the member should examine the relevant statute and make suitable qualification in his audit report in case adequate disclosures regarding accounting policies have not been made as per the statutory requirements. Similarly, the member should examine if the fundamental accounting assumptions have been followed in preparing the financial statements or not. In appropriate cases, he should consider whether, keeping in view the requirements of the applicable laws, a qualification in his report is necessary.

In the event of non-compliance by enterprises not governed by the Companies Act, in situations where the relevant statute does not require such disclosures to be made, the member should make adequate disclosure in his audit report

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without necessarily making it a subject matter of audit qualification.

In making a qualification / disclosure in the audit report, the auditor should consider the materiality of the relevant item. Thus, the auditor need not make qualification / disclosure in respect of items which, in his judgement, are not material.

A disclosure, which is not a subject matter of audit qualification, should be made in the auditor's report in a manner that it is clear to the reader that the disclosure does not constitute an audit qualification. The paragraph containing the auditor's opinion on true and fair view should not include a reference to the paragraph containing the aforesaid disclosure.

12. JOINT AUDIT

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the **advantages** that flow may be the following:

- (i) Sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower workload.
- (iv) Better quality of performance.
- (v) Improved service to the client.
- (vi) Displacement of the auditor of the company taken over in a take - over often obviated.
- (vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (viii) Lower staff development costs.
- (ix) Lower costs to carry out the work.

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(x) A sense of healthy competition towards a better performance.

The general **disadvantages** may be the following:

- (i) The fees being shared.
- (ii) Psychological problem where firms of different standing are associated in the joint audit.
- (iii) General superiority complexes of some auditors.
- (iv) Problems of co-ordination of the work.
- (v) Areas of work of common concern being neglected.
- (vi) Uncertainty about the liability for the work done.

The Institute of Chartered Accountants of India has issued Standard on Auditing (SA) 299 (Revised), "Joint Audit of Financial Statements" which lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing". This Standard deals with the special considerations in carrying out audit by joint auditors. It requires that–

- (i) the engagement partner and other key members of the engagement team from each of the joint auditors should be involved in planning the audit.
- (ii) the joint auditors should jointly establish an overall audit strategy which sets the scope, timing and direction of the audit, and also guides the development of the audit plan.
- (iii) before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:
 - (a) identify division of audit areas and common audit areas;
 - (b) ascertain the reporting objectives of the engagement;
 - (c) consider and communicate among all joint auditors the factors that are significant
 - (d) in directing the engagement team's efforts;
 - (e) consider the results of preliminary engagement activities, or similar engagements performed earlier.

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- (f) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.
- (iv) each of the joint auditors should consider and assess the risks of material misstatement and communicate to other joint auditors.
- (v) the joint auditors should discuss and document the nature, timing, and the extent of the audit procedures for (I) common and (II) specific allotted areas of audit to be performed.
- (vi) the joint auditors should obtain common engagement letter and common management representation letter.
- (vii) the work allocation document should be signed by all the joint auditors and communicated to those charged with governance.

It further states that, in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. On the other hand, all the joint auditors shall be jointly and severally responsible for:

- (i) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;
- (ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas;
- (iii) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;
- (iv) examining that the financial statements of the entity comply with the requirements of the relevant statutes;
- (v) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;
- (vi) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

In case a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other

joint auditors in writing prior to the completion of the audit.

It may be noted that the joint auditors are required to issue common audit report. However, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s).

[Note: Student may refer SA 299 (revised) "Joint Audit of Financial Statements" reproduced in "Auditing Pronouncements" for comprehensive knowledge.]



13. AUDIT OF BRANCH OFFICE ACCOUNTS

As per **section 128(1)** of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

It may be noted that all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within 7 days thereof, file with the Registrar a notice in writing giving the full address of that other place.

Students may also note that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

Sub-section (2) provides that where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place referred in (1).

Further, sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the

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company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per **rule 12 of the Companies (Audit and Auditors) Rules, 2014**, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

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

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- (a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter - component transactions that may require disclosure and the time-table for completion of audit; and
- (b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.



14. COST AUDIT

Cost Audit is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.

It is covered by **Section 148** of the Companies Act, 2013. The audit conducted under this section shall be in addition to the audit conducted under section 143.

As per section 148 the Central Government may by order specify audit of items of cost in respect of certain companies.

Further, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

In this regard, the Central Government has notified the Companies (Cost

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Records and Audit) Rules, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

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

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

Additionally, as per **clause (vi) to Paragraph 3 of the CARO, 2016**, the auditor has to report whether maintenance of cost records has been specified by the Central Government under section 148(1) of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.

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

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

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

Who can be Cost Auditor: The audit shall be conducted by a Cost Accountant who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed.

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

It may also be noted that the auditor conducting the cost audit shall comply with the cost auditing standards ("cost auditing standards" mean such standards as are issued by the Institute of Cost Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government).

Appointment of Cost Auditor: Rule 6 of the Companies (Cost Records and Audit) Rules, 2014 requires the companies prescribed under the said Rules to appoint an Auditor within 180 days of the commencement of every financial year. However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.

The certificate to be obtained from the cost auditor shall certify that the -

- (a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and Works Accountants Act, 1959 and the rules or regulations made thereunder;
- (b) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;
- (c) the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and
- (d) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

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Every referred company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of 30 days of the Board meeting in which such appointment is made or within a period of 180 days of the commencement of the financial year, whichever is earlier, through electronic mode, in Form CRA-2, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014.

The cost auditor appointed as such shall continue in such capacity till the expiry of 180 days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.

Removal of Cost Auditor: The cost auditor may be removed from his office before the expiry of his term, through a board resolution after giving a reasonable opportunity of being heard to the cost auditor and recording the reasons for such removal in writing.

It may be noted that the Form CRA-2 to be filed with the Central Government for intimating appointment of another cost auditor shall enclose the relevant Board Resolution to the effect.

It may further be noted that the above provisions shall not prejudice the right of the cost auditor to resign from such office of the company.

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

Remuneration of Cost Auditor: As per rule 14 of the Companies (Audit and Auditors) Rules, 2014-

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

- (ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;
- (b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

Qualification, Disqualification, Rights, Duties and Obligations of Cost Auditor: The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

Submission of Cost Audit Report:

(i) To the Board of Directors of the Company- The cost auditor shall submit the cost audit report along with his reservations or qualifications or observations or suggestions, if any, in Form CRA-3. He shall forward his report to the Board of Directors of the company within a period of 180 days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.

(ii) To the Central Government- The company shall within 30 days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein in Form CRA-4 in Extensible Business Reporting Language (XBRL) format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

Provided that the companies which have got extension of time of holding AGM under section 96 (1) of the Companies Act, 2013, may file form CRA-4 within resultant extended period of filing financial statements under section 137 of the Companies Act, 2013.

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If, after considering the cost audit report and the information and explanation furnished by the company as above, the Central Government is of the opinion, that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

Duty to Report on Fraud: The provisions of **section 143(12)** of the Companies Act, 2013 and the relevant rules on duty to report on fraud shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules.

Cost Audit Rules Not to Apply in Certain Cases: The requirement for cost audit under these rules shall not be applicable to a company which is covered under Rule 3, and,

- (i) whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue; or
- (ii) which is operating from a special economic zone.
- (iii) which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

Penal Provisions in Case of Default: If any default is made in complying with the provisions of this section,

- (a) the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147;
- (b) the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147.



15. PUNISHMENT FOR NON-COMPLIANCE

Section 147 of the Companies Act, 2013 prescribes following punishments for contravention:

- (1) If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year

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or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.

- (2) If an auditor of a company contravenes any of the provisions of section 139 section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees or four times the remuneration of the auditor, whichever is less.

It may be noted that if an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than **fifty thousand** rupees but which may extend to twenty-five lakh rupees **or eight times the remuneration of the auditor, whichever is less** .

- (3) Where an auditor has been convicted under sub-section (2), he shall be liable to-
- (i) refund the remuneration received by him to the company;
 - (ii) and pay for damages to the company statutory bodies or authorities or to **members or creditors of the company** for loss arising out of incorrect or misleading statements of particulars made in his audit report.
- (4) The Central Government shall, by notification, specify any statutory body or authority of an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages the such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.
- (5) Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in an fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the

time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

It may be noted that in case of criminal liability of an audit firm, in respect of liability other than fine, the concerned partner(s), who acted in a fraudulent manner or abetted or, as the case may be, colluded in any fraud shall only be liable.

TEST YOUR KNOWLEDGE

Correct/Incorrect:

State with reasons (in short) whether the following statements are correct or incorrect:

- (i) The first auditor of a Government company was appointed by the Board in its meeting after 10 days from the date of registration.
- (ii) Director's relative can act as an auditor of the company.
- (iii) If an LLP (Limited Liability Partnership Firm) is appointed as an auditor of a company, every partner of a firm shall be authorized to act as an auditor.
- (iv) AB & Co. is an audit firm having partners Mr. A and Mr. B. Mr. C, the relative of Mr. B is holding securities having face value of ₹ 2,00,000 in XYZ Ltd. AB & Co. is qualified for being appointed as an auditor of XYZ Ltd.
- (v) The auditor of a Ltd. Company wanted to refer to the minute books during audit but board of directors refused to show the minute books to the auditors.
- (vi) Manner of rotation of auditor will not be applicable to company A, which is having paid up share capital of ₹ 15 crores and having public borrowing from nationalized bank of ₹ 50 crore because it is a Private Limited Company.
- (vii) The auditor should study the Memorandum and Articles of Association to see the validity of his appointment.
- (viii) Managing director of A Ltd. himself appointed the first auditor of the company.
- (ix) A Chartered Accountant holding securities of S Ltd. having face value of ₹ 950 is qualified for appointment as an auditor of S Ltd.

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- (x) Mr. N, a member of the Institute of Company Secretary of India, is qualified to be appointed as auditor of XYZ Limited.
- (xi) The Board of Director of ABC Ltd., a listed company at Bombay Stock Exchange, is required to fill the casual vacancy of an auditor only after taking into account the recommendations of the audit committee.
- (xii) Bhartiya Gas Ltd. a Government Company, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the end of the financial year, who shall hold office till the end of the next Financial year.
- (xiii) CA K has resigned as an auditor after 2 months of his appointment in NML Ltd. He needs to file ADT-3 with the Registrar within 60 days from the date of resignation.
- (xiv) The Board of Director of ABC Ltd., a listed company at Bombay Stock Exchange, is required to fill the casual vacancy of an auditor only after taking into account the recommendations of the audit committee.
- (xv) Any partner of an LLP, who is appointed as an auditor of a company, can sign the audit report.
- (xvi) Audit committee is to be constituted by every public company to ensure better standards of corporate governance.
- (xvii) XYZ Ltd is engaged in manufacture of textiles specified under prescribed rules having total revenue of Rs.100 crore (including export turnover of Rs.88 crores in foreign exchange) in immediately preceding financial year. The said company is required to get cost audit conducted for immediately preceding financial year.
- (xviii) The auditor has to report under section 143 of companies act, 2013 whether company has adequate internal controls in place and overall effectiveness of such internal controls.
- (xix) Discovery of an offence of a fraud of Rs.100 lakh by auditor against the company committed by its officers is to be reported to Serious Fraud Investigation office(SFIO).
- (xx) The concept of "joint audit" has legal foothold under the Companies Act, 2013.

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Theoretical Questions

1. An auditor purchased goods worth ₹ 501,500 on credit from a company being audited by him. The company allowed him one month's credit, which it normally allowed to all known customers. Comment.
2. (a) Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2017-2018. Mr. Hanuman holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd. Comment.
(b) Managing Director of PQR Ltd. himself wants to appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director.
3. Under what circumstances the retiring Auditor cannot be reappointed?
4. Discuss the following:
 - (a) Ceiling on number of audits in a company to be accepted by an auditor.
 - (b) Filling of a casual vacancy of auditor in respect of a company audit.
 - (c) In Joint Audit, "Each Joint Auditor is responsible only for the work allocated to him".
5. ABC Ltd is a company incorporated in India. It has branches within and outside India. Explain who can be appointed as an auditor of these branches within and outside India. Also explain to whom branch auditor is required to report.
6. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.
7. Board of Directors of MN Ltd. wants to appoint CA B, a practicing Chartered Accountant, as an internal auditor of the company as they believe that they could not appoint any other person as an internal auditor other than practicing chartered accountant.
Examine the correctness of the statement of Board of Directors of MN Ltd. with respect to provisions of Companies Act, 2013.

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8. "CA. NM who is rendering management consultancy service to LA Ltd. wants to accept offer letter for appointment as an auditor of the LA Ltd. for the next financial year." Discuss with reference to the provision of the Companies Act, 2013.
9. Why Central Government permission is required, when the auditors are to be removed before expiry of their term, but the same is not needed when the auditors are changed after expiry of their term?
10. The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit.
11. According to Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report in accordance with the relevant provisions of the Act. Explain clearly the relevant provisions relating to signing of report.
12. The auditor shall make a report to the members of the company on the accounts examined by him. Explain with reference to relevant provisions of the Companies Act, 2013.
13. "The role of audit committee in corporate governance is not limited to making recommendation for appointment of auditors only." Discuss.
14. The auditor has to make inquiries on certain matters under section 143(1) of Companies Act, 2013. Discuss these matters.
15. Discuss the purpose of cost audit. What are the legal provisions regarding applicability of cost audit?

ANSWERS/SOLUTIONS

Answers to Correct/Incorrect

- (i) **Incorrect:** According to section 139(7) of the Companies Act, 2013, in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor- General of India within 60 days from the date of registration of the company. If CAG fails to make the appointment within 60 days, the Board shall appoint in next 30 days.
- (ii) **Incorrect:** As per section 141(3) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel.

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(iii) **Incorrect:** As per section 141(2) of the Companies Act, 2013, where a firm including a limited liability partnership (LLP) is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorised to act and sign on behalf of the firm.

(iv) **Incorrect:** As per the provisions of the Companies Act, 2013, a person is disqualified to be appointed as an auditor of a company if his relative is holding any security of or interest in the company of face value exceeding ₹ 1 lakh.

Therefore, AB & Co. shall be disqualified for being appointed as an auditor of XYZ Ltd. as Mr. C, the relative of Mr. B who is a partner in AB & Co., is holding securities in XYZ Ltd. having face value of ₹ 2 lakh.

(v) **Incorrect:** The provisions of Companies Act, 2013 grant rights to the auditor to access books of account and vouchers of the company. He is also entitled to require information and explanations from the company. Therefore, he has a statutory right to inspect the minute book.

(vi) **Incorrect:** According to section 139 of the Companies Act, 2013, the provisions related to rotation of auditor are applicable to all private limited companies having paid up share capital of ₹ 20 crore or more; and all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of ₹ 50 crore or more.

Although company A is a private limited company yet it is having public borrowings from nationalized bank of ₹ 50 crores, therefore it would be governed by provisions of rotation of auditor.

(vii) **Incorrect:** The auditor should study the Memorandum of Association to check the objective of the company to be carried on, amount of authorized share capital etc. and Articles of Association to check the internal rules, regulations and ensuring the validity of transactions relating to accounts of the company.

To see the validity of appointment, the auditor should ensure the compliance of the provisions of section 139, 140 and 141 of the Companies Act, 2013.

In addition, the auditor should study the appointment letter & the prescribed Form submitted to the Registrar of the Companies to see the validity of his appointment.

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- (viii) Incorrect:** As per section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a government company, shall be appointed by the Board of directors within 30 days from the date of registration of the company.

Therefore, the appointment of first auditor made by the managing director of A Ltd. is in violation of the provisions of the Companies Act, 2013.

- (ix) Incorrect:** As per the provisions of the Companies Act, 2013, a person is disqualified to be appointed as an auditor of a company if he is holding any security of or interest in the company.

As the chartered accountant is holding securities of S Ltd. having face value of ₹ 950, he is not eligible for appointment as an auditor of S Ltd.

- (x) Incorrect:** As per section 141 of the Companies Act, 2013, a person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.

Thus, Mr. N is disqualified to be appointed as an auditor of XYZ Limited.

- (xi) Correct:** Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

- (xii) Incorrect-** As per section 139(5), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

- (xiii) Incorrect:** As per section 140(2) of the Companies Act, 2013, the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar.

- (xiv) Correct:** Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual

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vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

(xv) Incorrect: Section 141(2) of the Companies Act, 2013 states that where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

(xvi) Incorrect. Under Section 177 of Companies Act, 2013 read together with Rule 4 of Companies(Appointment and qualification of Directors) Rules, 2014 prescribe that audit committee is to be constituted by every listed public company and following classes of public companies only:-

- (i) the Public Companies having paid up share capital of ten crore rupees or more; or
- (ii) the Public Companies having turnover of one hundred crore rupees or more; or
- (iii) the Public Companies which have, in aggregate, outstanding loans, debentures and deposits, exceeding fifty crore rupees:

Hence, the statement that all public companies are required to constitute audit committee is incorrect.

(xvii) Incorrect. The provisions of cost audit are not applicable in case of companies having revenue from exports in foreign exchange being more than 75% of its total revenue. As the company is having export turnover of Rs.88 crore in total revenues of Rs.100 core, the provisions of cost audit are not applicable to the said company.

(xviii) Incorrect: Under provisions of Section 143 of the companies Act, 2013, auditor has to report whether the company has adequate internal financial controls with reference to financial statements in place and operating effectiveness of such controls. The auditor has to report on adequacy and effectiveness of internal financial controls only and not internal controls.

(xix) Incorrect: Fraud of Rs.100.00 lakhs or above (i.e. Rs.1.00 crore or above) has to be reported to Central government (precisely to Secretary, Ministry of Corporate affairs) in Form ADT-4.

(xx) Correct: Under provisions of section 139(3), the members of a company may resolve to provide that audit shall be conducted by more than one auditor. Hence, the concept of "joint audit" has legal foothold also under Companies Act, 2013.

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Answers to Theoretical Questions

- 1. Purchase of Goods on Credit by the Auditor:** Section 141(3)(d)(ii) of the Companies Act, 2013 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding five lakh rupees.

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees five lakh, he is disqualified for appointment as an auditor of the company.

It will not make any difference if the company allows him the same period of credit as it allows to other customers on the normal terms and conditions of the business. The auditor cannot argue that he is enjoying only the normal credit period allowed to other customers. In fact, in such a case he has become indebted to the company and consequently he has deemed to have vacated his office.

- 2. (a) Auditor Holding Securities of a Company:** As per sub-section (3)(d)(i) of Section 141 of the Companies Act, 2013 read with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, the relative may hold security or interest in the company of face value not exceeding ₹ 1 lakh.

Also, as per sub-section 4 of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

In the present case, Mr. Hanuman, Chartered Accountant, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd. which is a subsidiary of Krishna Ltd. Therefore, the firm, M/s Ram and Hanuman Associates would be disqualified to be appointed as statutory auditor of Krishna Ltd., which is the holding

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company of Shiva Ltd., because one of the partners Mr. Hanuman is holding equity shares of its subsidiary.

- (b) Appointment of First Auditor of Company:** Section 139(6) of the Companies Act, 2013 lays down that the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company.

In the instant case, the appointment of Shri Ganapati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd. by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company within 30 days of registration of the company.

In view of the above, the Managing Director of PQR Ltd. should be advised not to appoint the first auditor of the company.

- 3. Circumstances where Retiring Auditor Cannot be Reappointed:** In the following circumstances, the retiring auditor cannot be reappointed-

- (i) A specific resolution has not been passed to reappoint the retiring auditor.
- (ii) The auditor proposed to be reappointed does not possess the qualification prescribed under section 141 of the Companies Act, 2013.
- (iii) The proposed auditor suffers from the disqualifications under section 141(3), 141(4) and 144 of the Companies Act, 2013.
- (iv) He has given to the company notice in writing of his unwillingness to be reappointed.
- (v) A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.
- (vi) A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance within the limits specified under section 141(3)(g) of the Companies Act, 2013.

- 4. Hints:**

- (a) Refer Para 7 Ceiling on number of Audits.**

(b) Refer Para 2.3 Filling of a Casual Vacancy

(c) Refer Para 12 Joint Audit.

5. Sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

6. **Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan.** In developing the joint audit plan, the joint auditors should:
- (a) identify division of audit areas and common audit areas;
 - (b) ascertain the reporting objectives of the engagement;
 - (c) consider and communicate among all joint auditors the factors that are significant
 - (d) in directing the engagement team's efforts;
 - (e) consider the results of preliminary engagement activities, or similar engagements performed earlier.

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- (f) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.
- (7) 1. As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not).
2. Or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies.
3. The internal auditor may or may not be an employee of the company.

Hence, the belief of Company is not correct.

8. **Section 141(3)(i) of the Companies Act, 2013** disqualifies a person for appointment as an auditor of a company who is engaged as on the date of appointment in management consultancy service as provided in section 144. Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor which are as under:

- (i) Accounting and book keeping services
- (ii) Internal audit.
- (iii) Design and implementation of any financially information system.
- (iv) Actuarial services
- (v) Investment advisory services.
- (vi) Investment banking services.
- (vii) Rendering of outsourced financial services
- (viii) Management services and
- (ix) Any other kind of services as may be prescribed

Therefore, CA. NM is advised not to accept the assignment of auditing as the management consultancy service is specifically notified in the list of services not to be rendered by him as per section 141(3)(i) read with section 144 of the Companies Act, 2013.

9. **Permission of Central Government for Removal of Auditor Under Section 140(1) of the Companies Act, 2013:** Removal of auditor before expiry of his term i.e. before he has submitted his report is a serious matter and may adversely affect his independence.

Further, in case of conflict of interest the shareholders may remove the auditors in their own interest.

Therefore, law has provided this safeguard so that central government may know the reasons for such an action and if not satisfied, may not accord approval.

On the other hand if auditor has completed his term i.e. has submitted his report and thereafter he is not re-appointed then the matter is not serious enough for central government to call for its intervention.

In view of the above, the permission of the Central Government is required when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term.

- 10. Joint Audit:** The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the **advantages** that flow may be the following:

- (i) Sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower workload.
- (iv) Better quality of performance.
- (v) Improved service to the client.
- (vi) Displacement of the auditor of the company taken over in a takeover often obviated.
- (vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (viii) Lower staff development costs.
- (ix) Lower costs to carry out the work.
- (x) A sense of healthy competition towards a better performance

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- 11. Duty to Sign the Audit Report:** As per **section 145** of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of **section 141(2)**.

Section 141(2) of the Companies Act, 2013 states that where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

The qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting.

- 12. Right to report to the members of the company on the accounts examined by him** – The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.
- 13.** Audit committee performs wide functions. The recommendation for appointment of auditors is only one of the several functions performed by audit committee. Under section 177 of companies Act, 2013, audit committee is responsible for following actions :-
- (i) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;]
 - (ii) review and monitor the auditor's independence and performance, and effectiveness of audit process;
 - (iii) examination of the financial statement and the auditors' report thereon;

- (iv) approval or any subsequent modification of transactions of the company with related parties;
- (v) scrutiny of inter-corporate loans and investments;
- (vi) valuation of undertakings or assets of the company, wherever it is necessary;
- (vii) evaluation of internal financial controls and risk management systems;
- (viii) monitoring the end use of funds raised through public offers and related matters.

Hence, audit committee oversees range of matters including those related to making recommendation for appointment of auditors etc.

- 14.** The auditor has to make inquires on following matters under section 143(1) of Companies Act, 2013:-
- (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 prejudicial to the interests of the company or its members;
 - (b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
 - (c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
 - (d) whether loans and advances made by the company have been shown as deposits;
 - (e) whether personal expenses have been charged to revenue account;
 - (f) where it is stated in the books and documents 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

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- 15.** The purpose of cost audit is to verify the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.

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

- (i) Classes of companies specified under item (A) "Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 50 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 25 crore or more.
- (ii) Classes of companies specified under item (B) "Non-Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 100 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 35 crore or more.

However, the requirement for cost audit does not apply to the following companies:-

- (i) whose revenue from exports, in foreign exchange, exceeds seventy five per cent of its total revenue; or
- (ii) Which is operating from a special economic Zone.
- (iii) which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

PART – II: QUESTIONS AND ANSWERS

QUESTIONS

PART – II A: Multiple Choice Questions based on Case Scenarios

Case Scenario - 1

Suresh Rana & Associates have been appointed as the statutory auditors of HAIL Ltd. by the Comptroller & Auditor General for the FY 2019-20. HAIL Ltd. is a Government company engaged in the manufacture of metro train coaches. During the course of audit, CA Suresh extended his scope of audit to cover efficiency, effectiveness and economy audit. CA Suresh Rana also asked his audit team to conduct expenditure audit as part of the audit engagement of HAIL Ltd.

During the course of audit, CA Suresh also found that the company has constructed its new stockyard for parking its metro coaches and maintenance of its metro coaches. However, the stockyard was not being used by the company for the designated purpose and the company continued using the rented stockyard. Suresh considered such expenditure as infructuous and avoidable expenditure.

The engagement partner also discussed with his team regarding the areas to be covered while conducting the audit of receipts. The reporting responsibilities of the engagement team were also discussed by the engagement partner with his team.

Based on the above facts, answer the following:-

1. **Statement 1:** Government audit provides public accounting of operational, management programme and policy aspects of public administration as well as accountability of officials administering them.
Statement 2: Government audit is equipped and intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end.
 - (a) Only statement 1 is correct
 - (b) Only statement 2 is correct
 - (c) Both 1 & 2 are correct
 - (d) Both 1 & 2 are incorrect
2. is conducted to ensure that the various programmes, schemes, and projects where large financial expenditure have been incurred are run economically and are yielding results expected of them:-
 - (a) Propriety audit
 - (b) Audit against Rules and orders

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- (c) Performance Audit
 - (d) Audit against Provision of funds
3. While conducting audit against provision of funds, the statutory auditors, M/s Suresh Rana & Associates must check:-
- (a) That each item of expenditure is covered by a sanction either general or special of a competent authority.
 - (b) That the expenditure incurred has been on the purpose for which the grant and appropriation has been provided and the amount of expenditure does not exceed the appropriation made.
 - (c) That the expenditure conforms to the relevant provision of the constitution.
 - (d) That the expenditure is in accordance with the financial rules, regulations and orders issued by the competent authority.
4. Which part of expenditure audit covers the scrutiny of the expenditure incurred on the construction of stockyard by the company which is considered as infructuous and avoidable by CA Suresh Rana?
- (a) Propriety Audit
 - (b) Audit against provision of funds
 - (c) Audit of sanctions
 - (d) Performance Audit
5. While conducting the audit of receipts of HAIL Ltd., which of the following area is to be covered as part of Audit of Receipts?
- 1. Whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities of HAIL Ltd.
 - 2. Whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or wilful omission or negligence to levy or collect taxes or to issue refunds.
 - 3. Whether the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made.
 - 4. Whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them.
- (a) Only statement 1 is correct
 - (b) Statements 1 & 2 are correct

- (c) Statements 1,2,3,4 are correct
- (d) Statements 1,2,3 are correct

Case Scenario - 2

RS & Associates have been appointed as the statutory auditors of MNO Ltd. for the Financial Year 2019-20. CA Ramesh is the engagement partner for the assignment. The management of MNO Ltd. has duly given a written representation letter to CA Ramesh regarding acknowledgement of its responsibility for the implementation and operation of accounting system and the internal control system of the company. The management has assured the audit firm that such accounting and internal control systems are designed and implemented to prevent and detect any misstatement on account of fraud or error.

During the course of audit, the auditor found that the wages cost has increased substantially as compared to the last year. On detailed checking CA Ramesh found that many new workers have been added to the workers list which appear to be dummy workers to CA Ramesh.

Further the auditor found that there was a fraud amounting to Rs. 2 crores committed during the year under audit by an officer of the company. Such fraud has already been reported by the Cost Accountant of the company, Mr. Sudesh, to the Central Government. The statutory auditors are considering their reporting responsibilities in this regard.

The audit team also realized that there is inadequate Internal Control System with respect to the following:

- The system of authorization and approval of transactions specially in the process of making purchases.
- The system of record keeping with respect to the assets.

Based on the above facts, answer the following:-

1. As the management of MNO Ltd. has given a written representation regarding its responsibility for prevention and detection of misstatement on account of fraud and error, M/s RS & Associates:-
 - (a) Should rely on such management representation and conduct its audit procedures without wasting much time and resources towards detection of fraud and error.
 - (b) Should not consider such management representation as a substitute for obtaining sufficient and appropriate audit evidence and design its audit procedures accordingly.
 - (c) Should not rely on such management representation and should obtain written representation from those charged with governance.
 - (d) Should concentrate on audit of accounting system and accounting policies so used by the company as the prevention and detection of fraud and error is the responsibility of the management.

2. The inclusion of dummy workmen in the workmen list by the management of MNO Ltd. as noticed by CA Ramesh amounts to:-
 - (a) Suppressing cash receipts
 - (b) Casting wrong total in cash book
 - (c) Inflating cash payment
 - (d) Misappropriation of goods
3. With respect to the fraud which has already been reported by The Cost accountant of the company, Mr. Sudesh, what is the responsibility of M/s RS & Associates in this regard?
 - (a) Since the reporting has been done to the Central Government by the cost accountant of the company, the statutory auditor has no responsibility for such fraud and its reporting.
 - (b) The cost accountant has detected and reported the fraud to the Central Government. The statutory auditor should not interfere in the work of the Cost Accountant.
 - (c) CA Ramesh should review the steps taken by the management with respect to the reported fraud and if he is not satisfied with such steps, he should request the management to perform additional procedures to enable him to satisfy himself that the matter has been appropriately addressed.
 - (d) CA Ramesh should obtain written representation from the management that once the matter is appropriately addressed, he will be duly informed by the management.
4.refers to events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud:-
 - (a) Fraud Risk Factors
 - (b) Misappropriation of assets
 - (c) Incentives/ Pressures
 - (d) Fraud
5. **Statement 1:** The risk of auditor not detecting a material misstatement resulting from employee fraud is greater than for management fraud.
Statement 2: The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error.
 - (a) Only statement 1 is correct
 - (b) Only statement 2 is correct
 - (c) Both 1 & 2 are correct
 - (d) Both 1 & 2 are incorrect

General MCQs

1.is a possible obligation that arises from the past events and whose existence will be confirmed only by the occurrence/ non occurrence of one or more uncertain future events not wholly within the control of the entity:-
 - (a) Provisions
 - (b) Reserves
 - (c) Contingent Liabilities
 - (d) Liability
2. In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures is known as :
 - (a) Monitoring
 - (b) Inspection
 - (c) Subsequent Audit procedures
 - (d) Compliance procedures
3. The concept of materiality is applied by the auditor :
 - (a) in planning and performing the audit
 - (b) in evaluating the effect of identified misstatements on the audit
 - (c) both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit
 - (d) none of the above is correct
4. _____ in which the auditor selects the sample without following a structured technique.
 - (a) Haphazard selection,
 - (b) Monetary Unit Sampling
 - (c) Block Sampling
 - (d) Structured Sampling
5. The persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity are :
 - (a) management
 - (b) those charged with governance
 - (c) audit committee
 - (d) board of directors

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PART II B – DESCRIPTIVE QUESTIONS

1. State with reason (in short) whether the following statements are true or false:
 - (i) Familiarity threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.
 - (ii) The auditor's opinion helps determination of the true and correct view of the financial position and operating results of an enterprise.
 - (iii) When establishing the overall audit strategy, the auditor need not determine materiality for the financial statements as a whole.
 - (iv) The policy of income recognition, in case of a Bank, should be subjective.
 - (v) The assignment is the creation of an equitable charge which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.
 - (vi) As per SA 240 the primary responsibility for the prevention and detection of fraud rests with Auditors.
 - (vii) Article 151 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.
 - (viii) In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments.

Chapter 1 - Nature, Objective and Scope of Audit

2.
 - (a) On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. The auditor may decide not to send a new audit engagement letter or other written agreement each period. Explain the factors an auditor considers to be appropriate to revise the terms of the audit engagement or to remind the entity of existing terms.
 - (b) The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats. Explain the guiding principles in this regard.
3.
 - (a) Discuss preconditions for an audit as per SA 210. Explain how would an auditor proceed to establish the presence of pre conditions for an audit.
 - (b) **Through its policies and procedures**, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished **through written or**

electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Explain the matters to be addressed in this context.

Chapter 2 - Audit Strategy, Audit Planning and Audit Programme

4. (a) Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. Explain in context with relevant SA, knowledge to be obtained by the auditor in establishing overall plan. Also explain how such an understanding would be helpful to the auditor.
- (b) Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after the completion of the previous audit and continues until the completion of the current audit engagement. Planning includes the need to consider certain matters prior to the auditor's identification and assessment of the risks of material misstatement. Explain clearly stating those matters also.
5. (a) The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, explain the auditor's assumptions about users of the financial statements.
- (b) Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Explain

Chapter 3 - Audit Documentation and Audit Evidence

6. (a) A new team member of GSR & Co., the auditors of Esteem Limited, was of the view that Audit Documentation would not serve any purpose at any stage of Audit. Explain.
- (b) While documenting the nature, timing and extent of audit procedures performed in case of audit of PQR Ltd, explain the important matters its auditor should record.
7. (a) When information to be used as audit evidence has been prepared using the work of a management's expert and having regard to the significance of expert's work for the auditor's purposes, explain the considerations auditor would consider for the purposes of his audit.
- (b) When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor has determined that management of XYZ Ltd has already performed a preliminary assessment of the entity's ability to continue as a going concern. Explain how would auditor of XYZ Ltd proceed in the above case.

Also explain how would the auditor proceed if such an assessment has not yet been performed by the management.

8. (a) Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. Explain. Also discuss the objectives of an auditor regarding Going concern as per relevant standard on auditing.
- (b) as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. Explain stating the auditor's responsibilities with regard to going concern.

Chapter 4 - Risk Assessment and Internal Control

9. (a) Auditor GR and Associates have been appointed to conduct audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditors do not think that it would be necessary to understand internal controls. Advise the auditor in this regard explaining clearly the benefits of understanding the internal control.
- (b) Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as materiality, the significance of the related risk etc. Explain in detail.
10. (a) The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the classes of transactions in the entity's operations that are significant to the financial statements, controls surrounding journal entries etc. Explain the other considerations in this regard.
- (b) The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. Explain in detail stating clearly the meaning of control activities and also discuss control activities that are relevant to the audit.

Chapter 5 - Fraud and Responsibilities of the Auditor in this Regard.

11. Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also report under clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016, the nature of fraud and amount involved. Explain the considerations an auditor would keep in mind for reporting under this clause.
12. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. Explain.

Chapter 6 - Audit in an Automated Environment

13. Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives. Discuss the activities performed by Data Center and Network operations. Also explain the meaning of General IT Controls in detail.

14. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the selection of audit samples. Explain giving other relevant points also in the above context of data analytics.

Chapter 7- Audit Sampling

15. Explain the following terms with reference to Audit Sampling :
- (i) Stratification
 - (ii) Tolerable misstatement
 - (iii) Tolerable rate of deviation
16. In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries. Explain in detail.

Chapter 8 - Analytical Procedures

17. The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. In this context, discuss the techniques available as Substantive Analytical Procedures.
18. Mention the Analytical Review procedures that may be useful as a means of obtaining audit evidence regarding various assertions relating to Trade receivables, loans and advances.

Chapter 9 - Audit of Items of Financial Statements

19. List out the steps to be taken by auditor while vouching/ verifying the 'Refund of General Insurance premium paid'.
20. Newton Ltd. has made loans and advances on the basis of following securities to various borrowers. As an auditor what type of documents can be verified to ensure that the company holds a legally enforceable security?
- (i) Shares and Debentures
 - (ii) Life Insurance Policy
 - (iii) Hypothecation of goods.

Chapter 10 - The Company Audit

21. During the audit of PQR Ltd. you as an auditor requested officers of the company to have access to secretarial records and correspondence which they refused to provide. Comment.

22. In exercise of the powers conferred by the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 141(3)(g) of the Companies Act, 2013).

Explain the provisions prescribed under Companies Act, 2013 in respect of ceiling on number of audits in a company to be accepted by an auditor.

23. Discuss the Provisions regarding appointment of Auditors -
- (i) First auditor of a Government company and a Non-Government company.
 - (ii) Subsequent auditor of a Government company and a Non- Government company.

Chapter 11 - Audit Report

24. The Auditor is fully satisfied with the audit of an entity in respect of its systems and procedures and wants to issue a report without any hesitation. Discuss the type of opinion that can be given and state giving reasoning.
25. The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally. Explain

Chapter 12 - Bank Audit

26. Your firm of auditors, SRG & Co., has been appointed as Statutory Central Auditors of Reliable Bank. Explain the reporting requirements of the Statutory Central Auditors (SCAs) in addition to their main audit report.
27. Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors. Explain the broad considerations about which the auditor is primarily concerned with obtaining evidence in carrying out audit of advances.

Chapter 13- Audit of Different Types of Entities

28. (a) Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession. Explain stating clearly the definition of Government auditing as discussed in U.N. Handbook on Govt Auditing and Developing Countries and also state Objectives of Govt audit.
- (b) Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. Explain

SUGGESTED ANSWERS

ANSWERS - MULTIPLE CHOICE QUESTIONS- Case Scenario-1

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

ANSWERS - MULTIPLE CHOICE QUESTIONS- Case Scenario-2

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

General MCQ's

- 1 (c)
- 2 (b)
- 3 (c)
- 4 (a)
- 5 (b)

Descriptive Answers

1. (i) **Incorrect:** Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests.
- (ii) **Incorrect:** The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise.
- (iii) **Incorrect :** When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole.

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(iv) **Incorrect:** The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Income from non-performing assets (NPA) is not recognized on accrual basis but is booked as income only when it is actually received.

(v) **Incorrect:** The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person.

(vi) **Incorrect:** As per SA 240 the primary responsibility for the prevention and detection of fraud rests with management. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

(vii) **Incorrect: Article 150** of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

Article 151 requires that the reports of the C&AG relating to the accounts of the Union/State shall be submitted to the President/Governor who shall cause them to be laid before House of Parliament/State Legislature.

(viii) **Correct:** In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

2. (a) On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- ◆ Any indication that the entity misunderstands the objective and scope of the audit.
- ◆ Any revised or special terms of the audit engagement.
- ◆ A recent change of senior management.
- ◆ A significant change in ownership.
- ◆ A significant change in nature or size of the entity's business.

- ◆ A change in legal or regulatory requirements.
 - ◆ A change in the financial reporting framework adopted in the preparation of the financial statements.
 - ◆ A change in other reporting requirements.
- (b) The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

- (i). For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
 - (ii). In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
 - (iii). Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
 - (iv). When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.
 - (v). If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.
3. (a) As per SA 210 “Agreeing the Terms of Audit Engagements”, preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

In order to establish whether the preconditions for an audit are present, the auditor shall:

- (a) Determine whether the financial reporting framework is acceptable; and
- (b) Obtain the agreement of management that it acknowledges and understands its responsibility:
 - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework;
 - (ii) For the internal control as management considers necessary; and
 - (iii) To provide the auditor with:

- Access to all information such as records, documentation and other matters;
- Additional information that the auditor may request from management for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

- (b) The firm should establish **policies and procedures** designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished **through written or electronic manuals**, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:

- ◆ How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- ◆ Processes for complying with applicable engagement standards.
- ◆ Processes of engagement supervision, staff training and coaching.
- ◆ Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- ◆ Appropriate documentation of the work performed and of the timing and extent of the review.
- ◆ Processes to keep all policies and procedures current.

4. (a) Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. As per SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", the auditor shall obtain an understanding of the following:
- (a) Relevant industry, regulatory and other external factors including the applicable financial reporting framework.
 - (b) The nature of the entity, including:
 - (i) its operations;
 - (ii) its ownership and governance structures;
 - (iii) the types of investments that the entity is making and plans to make,

including investments in special-purpose entities; and

(iv) the way that the entity is structured and how it is financed;

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

- (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
- (e) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations and to make judgements regarding the appropriateness of accounting policies and disclosures.

- (b) In the context of recurring audits, as per SA-300, "Planning an Audit of Financial Statements", Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:
 - 1. The analytical procedures to be applied as risk assessment procedures.
 - 2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
 - 3. The determination of materiality.
 - 4. The involvement of experts.
 - 5. The performance of other risk assessment procedures.
5. (a) The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:
- (i) Have a reasonable knowledge of business and economic activities and

accounting and a willingness to study the information in the financial statements with reasonable diligence;

- (ii) Understand that financial statements are prepared, presented and audited to levels of materiality;
- (iii) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- (iv) Make reasonable economic decisions on the basis of the information in the financial statements.

(b) Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- 1. Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- 2. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- 3. Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

6. (a) **The following are the purpose of Audit documentation:**

- 1. Assisting the engagement team to plan and perform the audit.
- 2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
- 3. Enabling the engagement team to be accountable for its work.
- 4. Retaining a record of matters of continuing significance to future audits.
- 5. Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- 6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

From the above, it can be concluded that Audit documentation serves a number of purposes and hence it would be incorrect to say that audit documentation would not serve any purpose at any stage of audit.

- (b) In documenting the nature, timing and extent of audit procedures performed, the auditor of PQR Ltd shall record:
- (i) The identifying characteristics of the specific items or matters tested.
 - (ii) Who performed the audit work and the date such work was completed; and
 - (iii) Who reviewed the audit work performed and the date and extent of such review.
7. (a) When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:
- (i) Evaluate the competence, capabilities and objectivity of that expert;
 - (ii) Obtain an understanding of the work of that expert; and
 - (iii) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.
- (b) When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.
- In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:
- (i) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or
 - (ii) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.
8. (a) Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future.
- General purpose financial statements are prepared using the going concern basis of accounting, unless management either
- (i) intends to liquidate the entity or to cease operations,
 - (ii) or has no realistic alternative but to do so.

When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

The objectives of the auditor regarding Going Concern are:

- (1) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;
- (2) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
- (3) To report in accordance with this SA.

(b) The auditor's responsibilities are:

- (1) to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and
- (2) to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

9. (a) The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Benefits of Understanding the Internal Control

An understanding of internal control assists the auditor in:

- (i) identifying types of potential misstatements;
- (ii) identifying factors that affect the risks of material misstatement, and
- (iii) designing the nature, timing, and extent of further audit procedures.

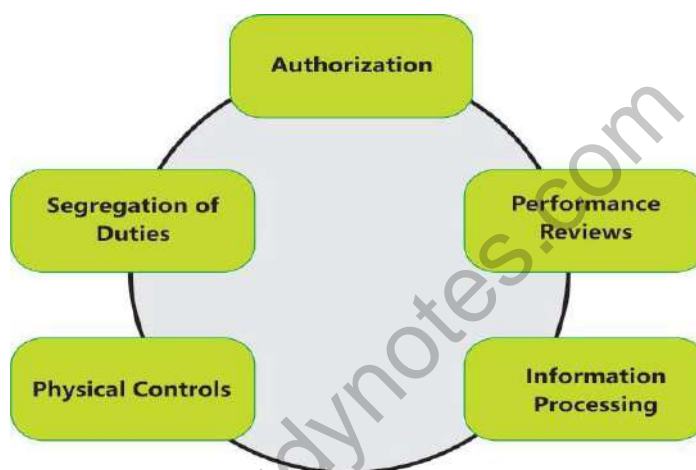
- (b) **Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:**
- ◆ Materiality.
 - ◆ The significance of the related risk.
 - ◆ The size of the entity.
 - ◆ The nature of the entity's business, including its organisation and ownership characteristics.
 - ◆ The diversity and complexity of the entity's operations.
 - ◆ Applicable legal and regulatory requirements.
 - ◆ The circumstances and the applicable component of internal control.
 - ◆ The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
 - ◆ Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.
10. (a) **The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following are as:**
- (a) The classes of transactions in the entity's operations that are significant to the financial statements;
 - (b) The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
 - (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;
 - (d) How the information system captures events and conditions that are significant to the financial statements;
 - (e) The financial reporting process used to prepare the entity's financial statements;
 - (f) Controls surrounding journal entries.
- (b) **The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. An audit requires an understanding of **only those control activities** related to **significant class of transactions, account balance, and disclosure** in the financial**

statements and the assertions which the auditor finds relevant in his risk assessment process.

Control activities are the policies and procedures that help ensure that management directives are carried out.

Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.

Examples of specific control activities include those relating to the following:



Control activities that are relevant to the audit are:

- Control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; or
 - Those that are considered to be relevant in the judgment of the auditor;
 - As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk.
11. Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report under clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:
- (i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.

- (ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.
 - (iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.
12. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.
13. "General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments.

General IT-controls that maintain the **integrity** of information and **security of data** commonly include controls over the following:"

- (i) Data center and network operations
- (ii) Program change
- (iii) Access security
- (iv) Application system acquisition, development, and maintenance (Business Applications)

These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls. Let us now learn about each of the General IT controls in more detail.

Data Center and Network Operations

Objective: To ensure that production systems are processed to meet financial reporting objectives.

Activities:

1. Overall Management of Computer Operations Activities
 2. Batch jobs – preparing, scheduling and executing
 3. Backups – monitoring, storage & retention
 4. Performance Monitoring – operating system, database and networks
 5. Recovery from Failures – BCP, DRP
 6. Help Desk Functions – recording, monitoring & tracking
 7. Service Level Agreements – monitoring & compliance
 8. Documentation – operations manuals, service reports
14. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:
- ◆ Check completeness of data and population that is used in either test of controls or substantive audit tests.
 - ◆ Selection of audit samples – random sampling, systematic sampling.
 - ◆ Re-computation of balances – reconstruction of trial balance from transaction data.
 - ◆ Reperformance of mathematical calculations – depreciation, bank interest calculation.
 - ◆ Analysis of journal entries as required by SA 240.
 - ◆ Fraud investigation.
 - ◆ Evaluating impact of control deficiencies.
15. (i) **Stratification** – The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).
- (ii) **Tolerable misstatement** – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.
- (iii) **Tolerable rate of deviation** – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an

appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

16. In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries.

Auditors realised that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organisation because they provide the reliability of the records. Sampling is used as a part of Test of controls. Auditor will check few internal controls and their operating effectiveness. Based on the conclusion derived, he can then design the sample size for test of details (i.e checking of transactions and balances)

If the internal control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains.

On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case.

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

Trend analysis — A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis — Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Reasonableness tests — Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts.

Structural modelling — A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

- 18. Analytical Review Procedures:** The following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables, loans and advances-
- (i) comparison of closing balances of trade receivables, loans and advances with the corresponding figures for the previous year;
 - (ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;
 - (iii) comparison of actual closing balances of trade receivables, loans and advances with the corresponding budgeted figures, if available;
 - (iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;
 - (v) comparison of significant ratios relating to trade receivables, loans and advances with similar ratios for other firms in the same industry, if available;
 - (vi) comparison of significant ratios relating to trade receivables, loans and advances with the industry norms, if available.
- 19. Refund of General Insurance Premium paid:** The refund of insurance premium may be because of earlier provisional payment of premium or may be a policy might have been cancelled at a later date. The auditor should take following steps while vouching such refunds:
- (i) Ascertain the reasons for refund of insurance premium.

- (ii) Examine insurance policy or cover note to find out the amount of premium.
- (iii) Verify advice of refund received from the insurance company. When refund is admitted, the insurance company sends the advice. This will be evidence as a covering letter to the cheque for the refund. Sometimes, a cheque is issued after a receipt is sent in advance to the insurance company.
- (iv) Scrutinise correspondence between the insurance company and the client.
- (v) Check entries in the bank book or the bank statement. If necessary, the counterfoil of the pay-in-slips can also be verified.

20. Documents to be seen in case of Securities:

Types of Security	Documents etc. to be seen
(i) Shares and debentures	The scrip and the endorsement thereon of the name of the transferee, in the case of transfer.
(ii) Life Insurance Policy.	Assignment of policy in favour of the lender, duly registered with the insurer
(iii) Hypothecation of goods	Deed of hypothecation or other document creating the charge, together with a statement of inventories held at the Balance Sheet date

21. Right of Access to secretarial records and correspondence:

1. Section 143(1) of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books of account and vouchers of the company kept at Registered or Head Office, branches and subsidiaries in the case of a Holding Company for conducting the audit.
2. Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties as Auditor. Therefore, he has a statutory right to inspect the secretarial records and correspondence.
3. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company. It is, therefore, essential for the auditor to refer to the secretarial records and correspondence which also includes Minute book. In the absence of the same, the auditor may not be able to vouch/verify certain transactions of the company.
4. The refusal to provide access to secretarial records and correspondence shall constitute limitation of scope as far as the auditor's duties are concerned.

5. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

22. Ceiling on number of Audits:

1. Before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in **section 141(3)(g)** of the Companies Act, 2013 which prescribes that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than **twenty companies** other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore, shall not be eligible for appointment as an Auditor of a Company.
 2. In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere. This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits.
 3. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.
- 23. (i) Appointment of First Auditor of a Government Company:** Section 139(7) of the Companies Act, 2013 provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

Appointment of First Auditor of a Non-Government Company: As per Section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a

Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

- (ii) **Appointment of Subsequent Auditor of a Government Company:** As per Section 139(5) of the Companies Act, 2013, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

Appointment of Subsequent Auditor of a Non-Government Company: As per section 139(1) of the Companies Act, 2013, every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

24. Unqualified Opinion:

1. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.
2. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.
3. An unqualified opinion also indicates that:
 - (i) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;
 - (ii) the financial statements comply with relevant statutory requirements and regulations; and
 - (iii) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

25. The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This SA promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.
26. **Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:**
- (a) Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
 - (b) Long Form Audit Report. (LFAR)
 - (c) Report on compliance with SLR requirements.
 - (d) Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
 - (e) Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
 - (f) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
 - (g) Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.
 - (h) Report on instances of adverse credit-deposit ratio in the rural areas.
27. Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

- (a) Amounts included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.
- (b) Advances represent amount due to the bank.

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- (c) Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances.
 - (d) There are no unrecorded advances.
 - (e) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.
 - (f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
 - (g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.
28. (a) Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession.

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government auditing is

- ◆ the objective, systematic, professional and independent examination
- ◆ of financial, administrative and other operations
- ◆ of a public entity
- ◆ made subsequently to their execution
- ◆ for the purpose of evaluating and verifying them,
- ◆ presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions
- ◆ by the responsible officials
- ◆ and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES :-

- (a) Accounting for Public Funds:-Government audit serves as a mechanism or process for public accounting of government funds.
- (b) Appraisal of Government policies:-It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.
- (c) Base for Corrective actions:-Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

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- (b) Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration. In India, the function of Government Audit is discharged by the independent statutory authority of the **Comptroller and Auditor General** through the agency of the **Indian Audit and Accounts Department**. Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executives of the spending agencies to the sanctioning or controlling authorities. The purpose or objectives of audit need to be tested at the touchstone of public accountability. The Comptroller and Auditor General (C&AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.